

Compensation

Eighth Edition

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COMPENSATION

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Preface

Want to go for a walk? In space? If you are a Russian cosmonaut, you can earn a bonus of \$1,000 for every space walk, up to three, per space trip. A contract listing specific tasks to be done on a space mission permits you to earn up to \$30,000 above the \$20,000 you earn while you are on the ground. In contrast, if you are a Microsoft engineer, the only thing you had to do for a recent pay increase was show up for work. A lackluster stock market eliminated the value of the astronomical stock options Microsoft had routinely doled out to employees. Employees were grumbling; top recruits were going elsewhere. What to do? Microsoft decided that its stock options were too risky, so it offered employees the chance to trade them in for actual shares of stock. Increase the value of people's pay and reduce the risk they face, and you get happier, more expensive people. And you can hire more. No word yet on improved performance, customer satisfaction, or even quality of new hires. Conclusion: *Pay matters*.

Many years ago, when Green Giant discovered too many insect parts in the pea pack from one of its plants, it designed a bonus plan that paid people for finding insect parts. Green Giant got what it paid for: insect parts. Innovative Green Giant employees brought insect parts from home to add to the peas just before they removed them and collected the bonus.

And speaking of bugs: A well-known software house designed a bonus plan that paid software engineers to find bugs in software code. Plan designers failed to realize that the people who found the bugs were the very same ones who wrote the buggy software code in the first place. Engineers joked about "writing me an SUV." Such problems are global. A British telephone information company paid a cash bonus based on how fast operators completed requests for information. Some operators discovered that the fastest way was to give out a wrong number or—even faster—just hang up on the caller. "We're actually looking at a new bonus scheme," says an insightful company spokesperson. Conclusion: *It matters what you pay for*.

Motorola trashed its old-fashioned pay system that employees said guaranteed a raise every six months if you were still breathing. The company replaced it with a system that paid for learning new skills and working in teams. Sounded good. Wasn't. Employees resented those team members who went off for six weeks of training at full pay while remaining team members picked up their work. Motorola was forced to trash its new-fashioned system, too. Conclusion: *It matters how you pay*.

We live in interesting times. Anywhere you look on the globe today, economic and social pressures are forcing managers to rethink how people get paid and what difference it makes. Traditional approaches to compensation are being questioned. But what is being achieved by all this experimentation and change? We have lots of fads and fashions, but is it all folderol? Where are the results?

In this book, we strive to cull beliefs from facts, wishful thinking from demonstrable results, and opinions from research. Yet when all is said and done, managing compensation is an art. As with any art, not everything that can be learned can be taught.

ABOUT THIS BOOK

This book is based on the strategic choices in managing compensation. We introduce these choices, which confront managers in the United States and around the world, in the

total compensation model in Chapter 1. This model provides an integrating framework that is used throughout the book. Major compensation issues are discussed in the context of current theory, research, and practice. The practices illustrate new developments as well as established approaches to compensation decisions.

Each chapter contains at least one *Cybercomp* to point you to some of the vast compensation information on the Internet. Real-life *Your Turn* exercises ask you to apply the concepts and techniques discussed in each chapter. For example, the Your Turn in Chapter 10 takes you through several exercises designed to explain how stock options work and how to value them. It also allows you to connect to real-time stock prices for up-to-date stock option valuations.

The authors also publish *Cases in Compensation*, an integrated casebook designed to provide additional practical skills that apply the material in this book. The casebook is available directly from the authors (telephone: 310-450-5301; e-mail: gtm1@cornell.edu). Completing the integrated case will help you develop skills readily transferable to future jobs and assignments. Instructors are invited to phone for more information on how *Cases in Compensation* can help translate compensation research and theory into practice and build competencies for on-the-job decisions.

But *caveat emptor*! “Congress raises the executive minimum wage to \$565.15 an hour,” reads the headline in the satirical newspaper *The Onion* (www.onion.com) (“America’s Finest News Source”). The article says that the increase will help executives meet the federal standard-of-easy-living. “Our lifestyles are expensive to maintain,” complains one manager. While the story in *The Onion* may clearly be fiction, sometimes it is more difficult to tell. One manager told us that when she searched for this textbook in her local bookstore, store personnel found the listing in their information system—under fiction!

WHAT’S NEW

All chapters of this edition have been completely revised. This edition gives greater emphasis to the importance of total compensation and its relevance for achieving sustainable competitive advantage. It reinforces our conviction that beyond how much people are paid, *how* they are paid, really matters. Managing pay means ensuring that the right people get the right pay for achieving objectives in the right way. Chapter 2 explains how to craft a total compensation strategy and examines the research on best practices. New chapters on performance-based pay dig into all forms of variable pay such as stock options, profit sharing, gain sharing, and team-based approaches. Person-based plans are compared to job-based plans, including recent developments in skill and competency approaches. Changes in competitive market analysis caused by outsourcing and global competition are covered, as well as the increased use of market pricing and broad banding. Employee benefits, always changing and always important, are covered in two chapters. Chapter 14 broadens its discussion of board-of-director compensation, executive compensation, and sales compensation. We have always used international examples in every section; we also have a completely revised chapter on global compensation. Software to aid both employees and manager decisions is covered, along with a renewed focus on measuring the value gained from pay systems. Ethical issues and the paucity of standards of conduct are discussed. Each chapter has links to interesting Internet sites discussing compensation and benefit issues.

Research and surveys about compensation are flourishing. We have included the best and most relevant of them, along with a reader's guide on how to be an informed consumer of this material.

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Chapter One

The Pay Model

Chapter Outline

Compensation: Definition, Please?

Society
Stockholders
Managers
Employees
Global Views—Vive la différence

Forms of Pay

Cash Compensation: Base
Cash Compensation: Merit Pay/
Cost-of-Living Adjustments
Cash Compensation: Incentives
Long-Term Incentives
Benefits: Income Protection
Benefits: Work/Life Focus
Benefits: Allowances
Total Earnings Opportunities: Present
Value of a Stream of Earnings
Relational Returns from Work

The Employment Relationship Combines Transactional and Relational Returns

*Variations in Transactional and Relational
Expectations*

A Pay Model

Compensation Objectives
Four Policies
Pay Techniques

Book Plan

Caveat Emptor—Be an Informed Consumer

- 1. Does the Research Measure Anything
Useful?*
- 2. Does the Study Separate Correlation
from Causation?*
- 3. Are There Alternative Explanations?*

Your Turn: Glamorous Internships? or House Elves?

A friend of ours writes that she is in one of the touring companies of the musical *Cats*. In the company are two performers called “swings” who sit backstage during each performance. Each swing must learn five different lead roles in the show. During the performance, the swing sits next to a rack with five different costumes and makeup for each of the five roles. Our friend, who has a lead in the show, once hurt her shoulder during a dance number. She signaled to someone offstage, and by the time she finished her number, the swing was dressed, in makeup, and out on stage for the next scene.

Our friend is paid \$2,000 per week for playing one of the cats in the show. She is expected to do a certain number of performances and a certain number of rehearsals per week. She gets paid for the job she does. The swing gets paid \$2,500 per week, whether she performs 20 shows that week or none. She is paid for knowing the five roles, whether she plays them or not.

Think of all the other employees, in addition to the performers, required for putting on a performance of *Cats*. Electricians, trombonists, choreographers, dressers, janitors, nurses, vocal coaches, accountants, stagehands, payroll supervisors, ushers, lighting technicians, ticket sellers—the list goes on. Consider the array of wages paid to these employees. Why does the swing get paid more than other performers? Why does the performer get paid more (or less) than the trombonist? How are these decisions made, and who is involved in making them? Whether the pay is our own or someone else's, compensation questions engage our attention.

Does the compensation received by all the people connected with *Cats* matter? Most employers believe that how people are paid affects people's behaviors at work, which affect an organization's chances of success. Compensation systems can help an organization achieve and sustain competitive advantage.¹

COMPENSATION: DEFINITION, PLEASE?

What image does the word “compensation” bring to mind? It does not mean the same thing to everyone. Yet how people view compensation affects how they behave at work. Thus, we begin by recognizing different perspectives.

Society

Some people see pay as a measure of justice. For example, a comparison of earnings of women with those of men highlights what many consider inequities in pay decisions. The gender pay gap in the United States, after adjustment for differences in education, experience, and occupation, narrowed from 36 percent in 1980 to 12 percent in 2003. But this measure masks tremendous variations. When educational choices are taken into account, women's earnings are 94 percent of those of men. For people age 21 to 35 who live alone and have no children, the gap is close to zero. (Of course, this constitutes a very small segment of the labor force.)² The gap even varies by cities. Most people were surprised when 2000 census data showed that women in Wichita, Kansas, earn about half of what men earn but that women in Oakland, California, earn more than men.³

Sometimes differences in compensation among countries are listed as a cause of loss of jobs from more developed, higher-wage economies to less developed ones. As Exhibit 1.1 reveals, labor costs in Mexico are about 12 percent of those in the United States. However,

¹E. Lawler III, *Rewarding Excellence* (San Francisco: Jossey-Bass, 2000); Patricia Zingheim and J. R. Schuster, *Pay People Right!* (San Francisco: Jossey-Bass, 2000); B. Gerhart, “Pay Strategy and Firm Performance,” in *Compensation in Organizations: Current Research and Practice*, eds. S. L. Rynes and B. E. Gerhart (San Francisco: Jossey-Bass, 2000); B. E. and Mark Huselid, “High Performance Work Systems and Firm Performance: A Synthesis of Research and Management Implications,” in *Research in Personnel and Human Resources*, ed. G. Ferris (Greenwich, CT: JAI Press, 1998); Barry Gerhart and Sara Rynes *Compensation: Theory, Evidence, and Strategic Implications* (Thousand Oaks, CA: Sage, 2003).

²H. J. Cummins, “Mommy Wage Gap: It's Real, but Is It Fair?” *Minneapolis Star & Tribune*, May 11, 2003; Genaro C. Armas, “White Men Still Outearn Other Groups,” *Associated Press*, March 21, 2003; F. Blau, and L. Kahn, “Analyzing the Gender Pay Gap,” *Quarterly Review of Economics and Finance* 39 (1999), pp. 625–646; Francine D. Blau and Lawrence M. Kahn, “Understanding International Differences in the Gender Pay Gap,” NBER Working Paper W8200, Cambridge, MA, April 2001.

³Laurent Belsie, “Gender Pay Gap Varies by City,” *Christian Science Monitor*, December 12, 2001.