CHAPTER 1

THE PAY MODEL

LEARNING OUTCOMES

- *Describe* how compensation is viewed differently by society, stakeholders, managers, and employees in Canada and around the world.
- *Discuss* major components of total returns for work.
- *Describe* the four strategic policies in the pay model and the techniques associated with them.
- *Discuss* the objectives of compensation in the pay model.

A friend of ours writes that she is in the touring company 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 signalled 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 to put 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 it's 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 behaviour at work, which affects an organization's chances of success. Compensation systems can help an organization achieve and sustain competitive advantage.[1]

COMPENSATION

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 must 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 Canada for full-time, full-year workers narrowed from 42 percent in 1967 to 30 percent in 2000. Despite this narrowing, and despite pay equity legislation, the gap persists, and always to the benefit of men. The latest studies show that, because women often withdraw temporarily from the labour force for family-related reasons, the resulting reduction in their experience has a serious impact on pay over the long term. For workers with less than two years' experience, the gap is only four percent, but it still exists.[2] However, a large portion of the wage gap still has yet to be explained.

Sometimes differences in compensation between countries are listed as a cause of loss of North American jobs to less developed economies. As **Exhibit 1.1(a)** reveals, labour costs in Mexico are about fourteen percent of those in Canada.[3] However, **Exhibit 1.1(b)** shows that when differences in productivity (the relative output for each dollar of pay) are factored in, the wage advantage of Mexico, Korea, and Taiwan disappears. Productivity is highest in France, the United States, and Germany.

EXHIBIT 1.1(a) Hourly Compensation Costs*

*U.S. Dollars

Voters may see compensation, pensions, and health care for public employees as the cause of increased taxes. Public policymakers and legislators may view changes in average pay as guides for adjusting eligibility for social services (provincial health care plans, welfare assistance, and the like).

Consumers sometimes see compensation as the cause of price increases. They may not believe that higher labour costs are to their benefit. On the other hand, other consumers have lobbied universities to insist on higher wages for labourers in Guatemala who sew shirts and caps bearing the university logo.[4]

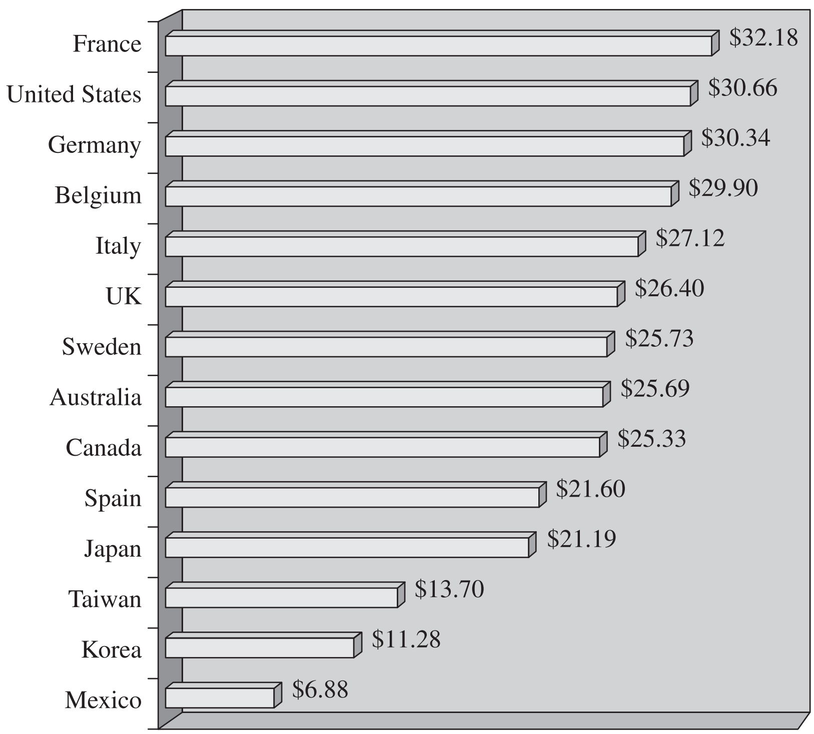
Stockholders

To stockholders, executive pay is of special interest. In Canada, pay for executives is supposed to be tied to the financial performance of the company. Unfortunately, this does not always happen. For example, between 1990 and 2001, share prices increased about 300 percent, corporate profits increased 116 percent, but CEO pay increased by 535 percent. Consider the high pay–low performance of BCE Inc.'s CEO Jean Monty in 2001. In a year when returns to BCE shareholders declined by 14 percent, Monty's pay increased by 452 percent.[5]

Managers

Managers also have a stake in compensation: It directly influences their success in two ways. First, it is a major expense. Competitive pressures, both internationally and domestically, force managers to consider the affordability of their compensation decisions. Studies show that in many enterprises labour costs account for more than 50 percent of total costs.[6] Among some industries,

EXHIBIT 1.1(b) Output per Dollar* of Pay around the World



*U.S. Dollars

such as financial or professional services or public employment such as education and government, this figure is even higher. However, even within an industry (e.g., automotive manufacturing, financial services), labour costs as a percent of total costs vary among individual firms.

In addition to treating pay as an expense, a manager also uses it to influence employee behaviours and improve organization performance. The way people are paid affects the quality of their work; their attitude toward customers; their willingness to be flexible or learn new skills or suggest innovations; and even their interest in unions or legal action against their employer. This potential to influence employees' behaviours, and subsequently the productivity and effectiveness of the organization, is another important reason to be clear about the meaning of compensation.[7]

Employees

The pay individuals receive in return for the work they perform is usually the major source of their financial security. Hence, pay plays a vital role in a person's economic and social well-being. Employees may see compensation as a *return in an exchange* between their employer and themselves, as an *entitlement* for being an employee of the company, or as a *reward* for a job well done. Compensation can be all of these things, though how many employees see their pay as a reward remains an open question.

Employees in large state-owned companies (e.g., in China) and in highly regulated countries (e.g., Sweden) sometimes believe their pay is an entitlement: their just due, regardless of their own performance or that of their employers. It is not uncommon for political leaders, trade unions, and employer federations in some countries such as Sweden and Germany to negotiate compensation policies that support their country's sociopolitical as well as economic priorities.[8]

Describing pay as a reward may sound farfetched to anyone who has reluctantly rolled out of bed to go to work. Even though writers and consultants use that term, do people really say, "They just gave me a reward increase," or "Here is my weekly reward check"? Sounds silly, doesn't it? Yet, if people see their pay as a return for their contributions and investments rather than a reward, and if writers and consultants persist in trying to convince them that pay is a reward, there is a disconnect that misleads both employees and managers. Employees invest in education and training; they contribute their time and energy at the workplace. Compensation is their return on those investments and contributions.[9]

Global

In English, compensation means to counterbalance, to offset, to make up for. However, if we look at the origin of the word in different languages, we get a sense of the richness of the meaning, which can combine entitlement, return, and reward.

In China, the traditional characters for compensation are based on the signs for logs and water; compensation provides the necessities in life. In today's China, however, the reforms of the last decade have led to use of a new word, *dai yu*, which refers to how you are treated or taken care of. When people talk about compensation, they ask each other "How about the 'dai yu' in your company?" rather than asking about the wages. So the benefits and training opportunities are very important.

Compensation in Japanese is *kyuyo*, which is made up of two separate characters (kyu and yo), both meaning "giving something." *Kyu* is an honourific used to indicate that the person doing the giving is someone of high rank, such as a feudal lord, an emperor, or a Samurai leader. Traditionally, compensation is thought of as something given by one's superior. Today, business consultants in Japan try to substitute the word *hou-syu*, which means reward, and has no associations with notions of superiors. The many allowances that are part of Japanese compensation systems translate as teate, which means "taking care of something." *Teate* is regarded as compensation that takes care of employees' financial needs. This concept is consistent

compensation
all forms of financial returns and tangible services and benefits employees receive as part of an employment relationship

with the family, housing, and commuting allowances that are still used in many Japanese companies.[10]

These contrasting perspectives of compensation—societal, stockholder, managerial, employee, and even global—add richness to the topic. But these perspectives can also cause confusion unless everyone is talking about the same thing. So let's define what we mean by compensation. **Compensation**, or pay (the words are used interchangeably in this book), refers to all forms of financial returns and tangible services and benefits employees receive as part of an employment relationship.

FORMS OF PAY

relational returns
psychological returns employees believe they receive in the workplace

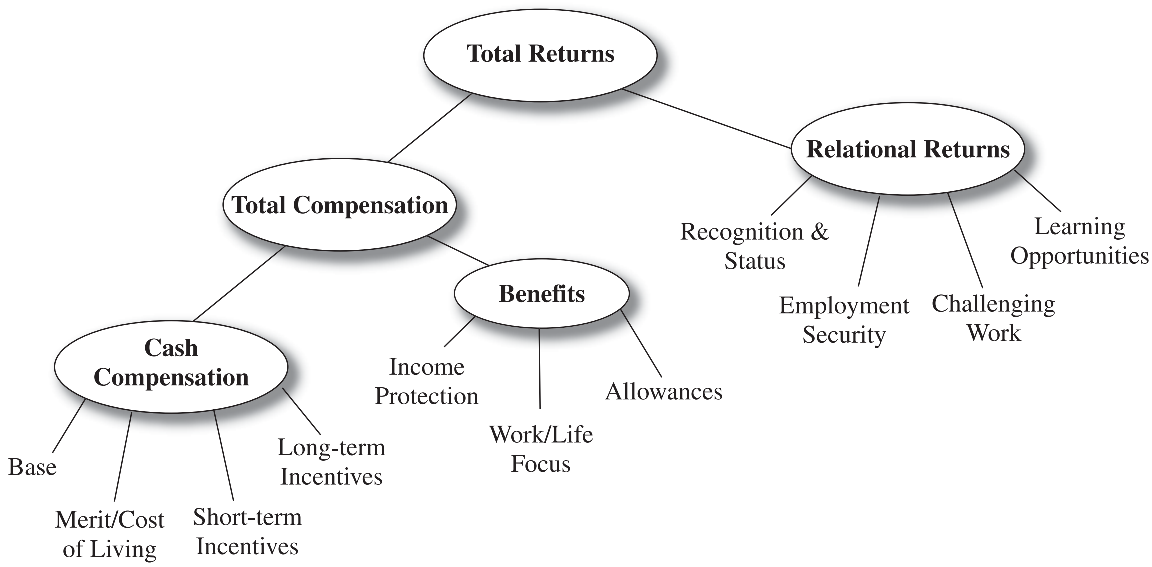
Exhibit 1.2 shows the variety of returns people may receive from work. They are categorized as *total compensation* and *relational returns*. The **relational returns** (development opportunities, status, opportunity to belong, challenging work, and so on) are the psychological returns people believe they receive in the workplace.[11] Total compensation includes pay received directly as cash (e.g., base, merit, incentives, cost-of-living adjustments) and indirectly as benefits (e.g., pensions, medical insurance, programs to help balance work and life demands, and so on). Programs to deliver compensation to people can be designed in a wide variety of ways, and a single employer typically uses more than one way. Both relational returns and total compensation can be designed to help the organization be successful. However, this book focuses on total compensation, which includes cash compensation and benefits.

Cash Compensation: Base

wage
pay calculated at an hourly rate

Base **wage** is the cash compensation that an employer pays for the work performed. Base wage tends to reflect the value of the work or skills and generally ignores differences attributable to individual employees. For example, the base wage for machine operators may be $12 an hour. However, some individual operators may receive more because of their experience and/or performance.

EXHIBIT 1.2 Total Returns for Work



Some pay systems set base wage as a function of the skill or education an employee possesses; this is common for engineers and schoolteachers. A distinction is often made between a wage and a **salary**, with salary referring to pay that is calculated at an annual or monthly rate rather than hourly.

salary
pay calculated at an annual or monthly rate

Periodic adjustments to base wages may be made on the basis of changes in the overall cost of living, changes in what other employers are paying for the same work, or changes in experience or skill.

Cash Compensation: Merit Increases and Cost-of-Living Adjustments

merit increase
increment to base pay in recognition of past work behaviour

cost-of-living adjustment
percentage increment to base pay provided to all employees regardless of performance

Almost all Canadian firms use merit pay increases.[12] **Merit increases** are given as increments to the base pay in recognition of *past* work behavior. Some assessment of past performance is made, with or without a formal performance evaluation program, and the size of the increase is varied with performance. Thus, outstanding performers could receive an 8 to 10 percent merit increase 8 months after their last increase, whereas an average performer may receive, say, a 4 to 5 percent increase after 12 or 15 months. In contrast, a **cost-of-living adjustment** gives the same percentage increase across the board to everyone, regardless of performance, in order to maintain pay levels relative to increases in the cost of living.

Cash Compensation: Incentives

Incentives tie pay increases directly to performance. However, incentives differ from merit adjustments. First, incentives do not increase the base wage, and so must be re-earned each pay period. Second, the potential size of the incentive payment generally will be known beforehand. Whereas merit pay programs evaluate the past performance of an individual and then decide on the size of the increase, the performance objective for incentive payments is specified ahead of time. For example, an auto sales agent knows the commission on a BMW versus the commission on a Honda prior to making the sale. Thus, although both merit pay and incentives can influence performance, incentives do so by offering pay to influence future behaviour. Merit, on the other hand, recognizes and rewards past behaviours. The distinction is a matter of timing.

Incentives can be tied to the performance of an individual employee, a team of employees, a total business unit, or some combination of individual, team, and unit. The performance objective may be expense reduction, volume increases, customer satisfaction, revenue growth, return on investments, or increases in total shareholder value—the possibilities are endless.[13]

incentives/variable pay
one-time payments for meeting previously established performance objectives

Because **incentives** are one-time payments, they do not have a permanent effect on labour costs. When performance declines, incentive pay automatically declines, too. Consequently, incentives are frequently referred to as *variable pay*.

Long-Term Incentives

Incentives may be short or long term. Long-term incentives are intended to focus employee efforts on multi-year results. Although they could take the form of a cash bonus, more typically these returns are in the form of stock ownership or options to buy stock at specified, advantageous prices. Thus, they straddle the categories of cash compensation and benefits. Some argue that stock options are not compensation at all, that they are more accurately described as an "equity incentive" granted by owners to employees.[14] We will treat options as part of the financial returns employees receive from employers in exchange for their work and ideas.

The idea behind stock options is that giving employees a financial stake in how well the organization is doing will focus them on such long-term financial objectives as return on investment, market share, return on net assets, and the like. Magna grants shares of stock to selected key contributors who make outstanding contributions to the firm's success. Some companies have extended stock ownership beyond the ranks of managers and professionals. Sun Microsystems, Yahoo, Pepsi, Wal-Mart, and Starbucks offer stock options to all their employees. These companies believe that having a stake in the company supports a culture of ownership. They hope that employees will behave like owners.[15]

Benefits: Income Protection

Exhibit 1.2 shows that employee benefits, including income protection, work-life programs, and allowances, are also part of total compensation. Exhibit 1.2 shows that employee benefits, including income protection, work-life programs, and allowances, are also part of total compensation. Some income protection programs are legally required. For example, employers make contributions to the Canada/Quebec Pension Plan, Employment Insurance, and Workers' Compensation. Different countries have different lists of mandatory benefits.

Health insurance, dental insurance, pensions, and life insurance, are common benefits. They help protect employees from the financial risks inherent in daily life. Often, companies can provide these protections to employees more cheaply than employees can obtain them for themselves. Because the cost of providing benefits has been rising, they are an increasingly important form of pay.[16]

Benefits: Work-Life Programs

Programs that help employees better integrate their work and life responsibilities include time away from work (vacations, jury duty), access to services to meet specific needs (drug counselling, financial planning, referrals for child and elder care), and flexible work arrangements (telecommuting, nontraditional schedules, nonpaid time off). Responding to the tight labour market for highly skilled employees and the changing demographics of the work force (two-income families who demand employer flexibility so that family obligations can be met), many Canadian employers are giving a higher priority to these benefits forms. Husky Injection Molding in Bolton, Ontario offers a healthy workplace program with three main components—a wellness centre, a fitness centre, and a nutrition program.[17]

Benefits: Allowances

allowances
compensation to provide for items that are in short supply

Allowances often grow out of whatever is in short supply. In Korea and Japan, housing (dormitories and apartments) and transportation allowances are frequently part of the pay package. Some Japanese companies continue to offer a "rice allowance" based on number of dependents, a practice that grew out of post–World War II food shortages. Almost all companies starting operations in China discover that housing, transportation, and other allowances are expected. Companies that resist these allowances must come up with other ways to attract and retain talented employees. In many European countries, managers expect a car to be provided. The issue then becomes what make and model.

Total Earnings Opportunities: Present Value of a Stream of Earnings

Up to this point we have treated compensation as something paid or received at a moment in time. But compensation decisions have a temporal effect. Say you have a job offer of $30,000. If you stay with the firm five years and receive an annual increase of seven percent every five years, you will be earning $39,324 in five years. The expected cost commitment of the decision to hire you turns out to be $224,279 ($30,000 base compounded by seven percent for five years, plus benefits equal to 30 percent of base). So the decision to hire you implies a commitment of at least a quarter of a million dollars from your employer.

A present value perspective shifts the choice from comparing today's initial offers to consideration of future bonuses, merit increases, and promotions. Andersen Consulting, for example, says that their relatively low starting offers will be overcome by larger future pay increases. In effect, Andersen is selling the present value of the future stream of earnings. But few students apply that same analysis in calculating the future increases required to offset the lower initial offers. Hopefully, all students who get through Chapter One will now do so.

Relational Returns from Work

Why does Bill Gates still show up for work every morning? Why do all the Microsoft millionaires—relatively young employees made wealthy by the astounding performance of Microsoft stock—continue to write code? There is no doubt that nonfinancial returns from work create intrinsic motivation that has a substantial effect on employees' behaviour. Exhibit 1.2 includes recognition and status, employment security, challenging work, and opportunities to learn. Other relational forms might include personal satisfaction from successfully facing new challenges, teaming with great co-workers, and the like. Such factors are part of the total rewards, which is a broader umbrella than total compensation. So, although this book is about total compensation, let's not forget that compensation is only one of many factors affecting people's decisions about work. The .Net Worth box provides an example of a Canadian company using both total compensation and relational returns to attract new employees.

.NET WORTH

What Attracts Employees to a Job?

The findings from a 2002 study of 765 Canadian companies by compensation consultants Towers Perrin illustrate the importance of both total compensation and relational returns. Although competitive base pay is the top attraction to a job, the second most important is opportunities for advancement. In third place is competitive health care benefits. The fourth and fifth most important factors that make a job attractive to Canadians are work/life balance and recognition for work, respectively. Other important factors include challenging work, learning and development opportunities, and a competitive retirement package.[1]

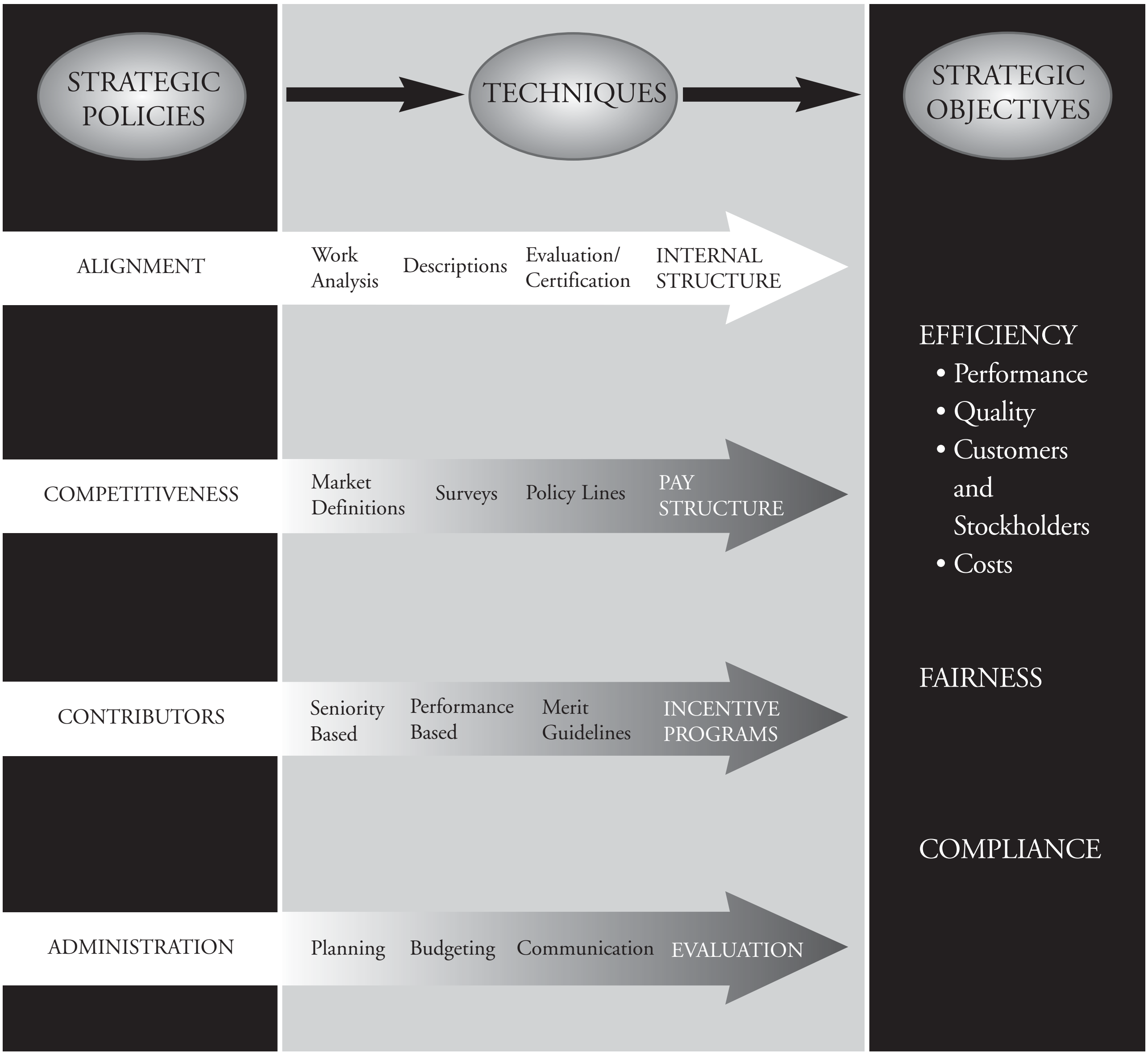
One Canadian company that promotes both total compensation and relational returns is IMS Health, a medical information and consulting company with offices in Montreal and Toronto. Their Web site highlights total compensation, including pay, benefits, incentives, recognition, social events, work/life balance arrangements, career growth, and more.[2]

Sources:
[1] *The Towers Perrin Talent Report: New Realities in Today's Workforce* (Canadian Report). Toronto, ON: Towers Perrin, 2002, p.11.
[2] www.imshealthcanada.com (June 23, 2003)

A PAY MODEL

The pay model shown in **Exhibit 1.3** serves as both a framework for examining current pay systems and a guide to most of this book. It contains three basic building blocks: (1) the strategic compensation objectives, (2) the strategic policies that form the foundation of the compensation system, and (3) the techniques of compensation.

EXHIBIT 1.3 The Pay Model



Strategic Compensation Objectives

strategic objectives

goals identified by an organization as necessary for the achievement of its strategy for success

Pay systems are designed and managed to achieve certain **strategic objectives**. The basic objectives, shown at the right side of the model, include efficiency, fairness, and compliance with laws and regulations. The efficiency objective can be stated more specifically: (1) improving performance, quality, delighting customers and stockholders, and (2) controlling labour costs. Compensation objectives at Medtronic and AES are contrasted in **Exhibit 1.4**. Medtronic is a medical technology company that pioneered cardiac pacemakers. Its compensation objectives emphasize performance, business success, and salaries that are competitive with other companies whose financial performance matches Medtronic's. AES generates and markets electricity around the world. Its goal is to "provide electricity worldwide in a socially responsible way." The notion of social responsibility pervades the company.

Fairness is a fundamental objective of pay systems. In Medtronic's objectives, fairness is reflected in "ensure fair treatment" and "be open and understandable." AES's mission statement acknowledges that, "Defining what is fair is often difficult, but we believe it is helpful to routinely question the relative fairness of alternative courses of action. It does not mean that everyone gets treated equally, but instead treated fairly or with justice given the appropriate situation."[18]

Thus, the fairness objective attempts to ensure fair treatment for all employees by recognizing both employee contributions (e.g., higher pay for greater performance, experience, or training) and employee needs (e.g., a fair wage as well as fair procedures). **Procedural fairness** is concerned with the processes used to make decisions about pay.[19] It suggests that the way a pay decision is made may be as important to employees as the results of the decision.

procedural fairness

fairness of the process used to make a decision

Compliance as a pay objective involves conforming to various federal, provincial, and territorial compensation laws and regulations. As these laws and regulations change, pay systems may need to be adjusted to ensure continued compliance.

There probably are as many statements of pay objectives as there are employers. In fact, highly diversified firms such as George Weston Ltd and Onex Corp, which compete in multiple lines of businesses, may have different pay objectives for different business units. Objectives at these companies emphasize the increased complexity of the business and importance of integrity

EXHIBIT 1.4 Comparison of Pay System Objectives at Medtronic and AES

Medtronic	AES
▪ Support objectives and increased complexity of business ▪ Minimize increases in fixed costs ▪ Emphasize performance through variable pay and stock ▪ Competitiveness aligned with financial performance: 50th percentile performance paid at 50th percentile of market, 75th percentile performance paid at 75th percentile of market	Our guiding principles are to act with integrity,treat people fairly, have fun, and be involvedin projects that provide social benefits. This means we will ▪ Help AES attract self-motivated, dependable people who want to keep learning new things ▪ Hire people who really like the place and believe in the AES system ▪ Pay what others are paid both inside and and outside AES, but willing to take less to join AES ▪ Use teams of employees and managers to manage the compensation system ▪ Make all employees stockholders

(customers, quality), competitiveness (costs), ability to attract and retain quality people (performance), and having fun.

Objectives serve several purposes. First, they guide the design of the pay system. Consider the employer whose objective is to reward outstanding performance. That objective will determine the pay policy (e.g., pay for performance) as well as the elements of pay plans (e g., merit and/or incentives). Another employer's objectives may be to develop a flexible, continuously learning workforce through job design, training, and team-building techniques. A pay system that is aligned with this employer's objectives may have a policy of paying salaries that at least equal those of competitors and that go up with increased skills or knowledge. This pay system could be very different from our first example where the focus is on performance. Thus, different objectives guide the design of different pay systems.

Objectives also serve as the standards for judging the success of the pay system. If the objective is to attract and retain the best and the brightest, yet skilled employees are leaving to take higher paying jobs with other employers, the system may not be performing effectively. Although there may be many nonpay reasons for turnover, objectives provide standards for evaluating the effectiveness of a pay system.

Four Strategic Policies

Every employer must address the strategic policy decisions shown on the left side of the pay model: (1) internal alignment, (2) external competitiveness, (3) employee contributions, and (4) administration of the pay system. These policies form the foundation on which pay systems are built. These policies also serve as guidelines for managing pay in ways that accomplish the system's objectives.

Internal Alignment. Internal alignment refers to comparisons between jobs or skill levels inside a single organization. Jobs and people's skills are compared in terms of their relative contributions to the organization's objectives. How, for example, does the work of the programmer compare with the work of the systems analyst, the software engineer, and the software architect? Does one contribute to providing solutions to customers and satisfying shareholders more than another? Does one require more knowledge or experience than another? Internal alignment refers to the pay rates both for employees doing equal work and for those doing dissimilar work. In fact, determining what is an appropriate difference in pay for people performing different work is one of the key challenges facing managers.

Internal alignment policies affect all three compensation objectives. Pay relationships within the organization affect employee decisions to stay with the organization, to become more flexible by investing in additional training, or to seek greater responsibility. By motivating employees to choose increased training and greater responsibility in dealing with customers, pay relationships indirectly affect the capabilities of the workforce and hence the efficiency of the entire organization. Fairness is affected in employees' comparisons of their pay to the pay of others in the organization. Basic fairness is provided by Canadian human rights laws, which make paying on the basis of race, gender, age, and other grounds, illegal.

external competitiveness
comparison of compensation with that of competitors

External Competitiveness. **External competitiveness** refers to compensation relationships external to the organization; i.e., comparison with competitors. How should an employer position its pay relative to what competitors are paying? *How much* do we wish to pay accountants in comparison to what other employers would pay them? *What mix* of pay forms—base, incentives, stock, benefits—will help achieve the compensation objectives? Employers have several policy options. Medtronic's policy is to pay competitively in its market based on its financial performance versus the financial performance of its competitors, while AES's policy is to expect people to be willing to take less to join the company.

Increasingly, organizations claim their pay systems are market driven, i.e., based almost exclusively on what competitors pay. However, "market driven" gets translated into practice in different ways. Some employers may set their pay levels higher than their competition, hoping to attract the best applicants. Of course, this assumes that someone is able to identify and hire the "best" from the pool of applicants.

What mix of pay forms a company uses is also part of its external competitive policy. Medtronic sets its base pay to match its competitors but ties incentives to performance. Plus it offers stock options to all its employees to promote a culture of ownership. The assumption is that owners will pay closer attention to the business. Further, Medtronic believes its benefits, particularly the emphasis on programs that balance work and life, make it a highly attractive place to work. Medtronic believes it is *how* it positions its pay, and *what forms* it uses, that gives it an advantage over its competitors. A Medtronic competitor, say MDS, may offer lower base pay but greater opportunity to work overtime or fatter bonuses. AES believes making all employees stockholders is consistent with its emphasis on social responsibility.

External competitiveness decisions—both how much, and what forms—have a twofold effect on objectives: (1) to ensure that the pay is sufficient to attract and retain employees—if employees do not perceive their pay as competitive in comparison to what other organizations are offering for similar work, they may be more likely to leave—and (2) to control labour costs so that the organization's prices of products or services can remain competitive. Thus, external competitiveness directly affects both efficiency and fairness. And it must do so in a way that complies with relevant legislation.

Employee Contributions. The policy on employee contributions refers to the relative emphasis placed on performance. Should one programmer be paid differently from another if one has better performance and/or greater seniority? Or should all employees share in the organization's financial success (or failure) via incentives based on profit? Perhaps more productive teams of employees should be paid more than less productive teams.

The degree of emphasis to be placed on performance is an important policy decision, since it directly affects employees' attitudes and work behaviours. Employers with strong pay-for-performance policies are more likely to place greater emphasis on incentives and merit pay. Starbucks emphasizes stock options and sharing the success of corporate performance with the employees. General Electric emphasizes performance at the unit, division, and companywide level. Recognition of contributions also affects fairness, since employees need to understand the basis for judging performance in order to believe that their pay is fair.

Administration. Policy regarding administration of the pay system is the last building block in our model. Although it is possible to design a system that is based on internal alignment, external competitiveness, and employee contributions, the system will not achieve its objectives unless it is managed properly.

The greatest system design in the world is useless without competent management. Managers choose what forms of pay to include and how to position pay against competitors. They must communicate with employees and judge whether the system is achieving its objectives. They must ask, Are we able to attract skilled workers? Can we keep them? Do our employees feel our system is fair? Do they understand how their pay is determined? How do the better-performing firms, with better financial returns and a larger share of the market, pay their employees? Are the systems used by these firms different from those used by less successful firms? How do our labour costs compare to our competitors? Answers to these questions are necessary in order to tune or redesign the system, to adjust to changes, and to highlight potential areas for further investigation. At AES, there is no compensation department, nor even a human resources management department. Instead, teams of employees make all the compensation decisions. The assumption is that this approach will ensure that everyone feels they are being treated fairly.

Pay Techniques

The remaining portion of the pay model in Exhibit 1.3 shows the pay techniques. The exhibit provides only an overview, since techniques are discussed throughout the rest of the book. Techniques tie the four basic policies to the pay objectives. Internal alignment typically is established through a sequence that starts with analysis of the work done and the people needed to do it. Information about the person and/or the job is collected, organized, and evaluated. Based on these evaluations, a structure of the work is designed.

This structure depicts relationships among jobs and skills or competencies inside an organization. It is based on the relative importance of the work in achieving the organization's objectives. The goal is to establish a structure that is aligned with and supports the organization's objectives. In turn, fairness of the pay system affects employee attitudes and behaviours as well as the organization's regulatory compliance.

External competitiveness is established by setting the organization's pay level in comparison with how much competitors pay for similar work and what pay forms they use. The total compensation is determined by defining the relevant labour markets in which the employer competes, conducting surveys to find out how and what other employers pay, and using that information in conjunction with the organization's policy decisions to generate a pay structure. The pay structure influences how well the organization is able to attract and retain a competent workforce and to control its labour costs.

The relative emphasis on employee contributions is established through performance and/or seniority-based increases, incentive plans, and stock options and other performance-based approaches. Increasingly, organizations in Canada and around the globe are using some form of incentive plan to share their success with employees. In addition to managing costs, these practices are intended to affect employee attitudes and behaviours, in particular the decisions to join the organization, to stay, and to perform effectively.

Uncounted variations in pay techniques exist; many are examined in this book. Surveys report differences in compensation policies and techniques among firms. Indeed, many consulting firms have Web pages in which they report their survey results. You can obtain updated information on various practices simply by surfing the Web.

BOOK PLAN

Compensation is such a broad and compelling topic that several books could be devoted to it. The focus of this book will be on the design and management of compensation systems. To aid in understanding how and why pay systems work, our pay model, which emphasizes the key strategic objectives, policies, and techniques, also provides the structure for much of the book.

Chapter 2 discusses how to formulate and implement a compensation strategy. We analyze what it means to be strategic about how people are paid and how compensation can help achieve and sustain an organization's competitive advantage.

The pay model plays a central role in formulating and implementing an organization's pay strategy. The pay model identifies four basic policy decisions that are the core of the pay strategy. After we discuss strategy, the next sections of the book will examine each in detail. The first, *internal alignment* (Chapters 3 through 6), examines pay relationships within a single organization. The next section (Chapters 7 and 8) examines *external competitiveness*—the pay relationships among competing organizations—and analyzes the influence of market-driven forces.

Once the compensation rates and structures are established, other issues emerge. How much should we pay each individual employee? How much and how often should a person's pay be increased, and on what basis—experience, seniority, or performance? Should pay increases be contingent on the organization's and/or the employee's performance? How should the organization share its success (or failure) with employees? Stock awards, profit sharing, bonuses, merit pay? These are examples of employee contributions, the third building block in the model (Chapters 9 and 10). After that, we cover employee services and benefits (Chapter 11). The role of governments and unions in compensation is examined in Chapter 12. We conclude with managing the compensation system (Chapter 13), which includes planning, budgeting, evaluating, and communicating. More detail on global compensation systems is provided in the Appendix.

Even though the book is divided into sections that reflect the pay model, that does not mean that pay policies and decisions are discrete. All policy decisions are interrelated. Together, they influence employee behaviours and organization performance, and can be a source of competitive advantage.

Our intention throughout the book is to examine alternative approaches. We believe that there rarely is a single correct approach; rather, alternative approaches exist or can be designed. The one most likely to be effective depends on the circumstances. We hope that this book will help you to become better informed about these options and how to design new ones. Whether as an employee, a manager, or an interested member of society, you should be able to assess effectiveness and fairness of pay systems.

CAVEAT EMPTOR—BE AN INFORMED CONSUMER

Our understanding of compensation management grows as research evidence accumulates. Nevertheless, evidence needs to be evaluated to determine its quality, relevance, and information value. Managers need to be informed consumers. Belief is a poor substitute for informed judgment.

Therefore, your challenge is to become an informed consumer of compensation information. How-to-do-it advice abounds, best-practices prescriptions are plentiful, and academic journals are packed with pay-related theory and research. We end the chapter with a brief consumer's guide that includes three questions.

1. Does the Research Measure Anything Useful?

How useful are the variables used in the study? How well are they measured? For example, many studies purport to measure organization performance. However, performance may be determined by accounting measures such as return on assets or cash flow, financial measures such as earnings per share or total shareholder return, operational measures such as scrap rates or defect indicators, or qualitative measures such as customer satisfaction. Performance may even be evaluated by the opinions of compensation managers, as in: How effective is your gain-sharing plan? (Answer choices are: highly effective, somewhat effective, somewhat ineffective, highly ineffective.) So the informed consumer must ask, Does this research measure anything important?

2. Does the Study Separate Correlation from Causation?

Correlation does not mean causation. For example, many studies investigate the relationship between the use of performance-based pay and performance. Just because the use of gain-sharing plans is related to improved performance does not mean that it caused the improvement. Other factors may be involved. Perhaps new technology, reengineering, improved marketing, or the general expansion of the local economy underlie the results.

Once we are confident that our variables are defined and measured accurately, we must be sure that they are actually related. Most often this is addressed through the use of statistical analyses. The correlation coefficient is a common measure of association that indicates how changes in one variable are related to changes in another. Many research studies use a statistical analysis known as regression analysis. One output from a regression analysis is the R^2. The R^2 is much like a correlation in that it tells us what percentage of the variation is accounted for by the variables we are using to predict or explain. For example, one study includes a regression analysis of the change in CEO pay due to change in company performance. The resulting R^2 of between 0.8 percent and 4.5 percent indicates that only a very small amount of change in CEO pay is related to changes in company performance.

Note that relation is not necessarily causation. For example, just because a manufacturing plant initiates a new incentive plan and the facility's performance improves, we cannot conclude that the incentive plan caused the improved performance. The two changes are associated or related, but causation is a tough link to make.

Too often, case studies, benchmarking studies of best practices, or consultant surveys are presented as studies that reveal cause and effect. They are not. Case studies are descriptive accounts whose value and limitations must be recognized. Just because the best-performing companies are using a practice does not mean the practice is causing the performance. For a long time, IBM pursued a full-employment policy. Clearly, that policy did not cause the value of IBM stock to increase or improve IBM's profitability. Arguably, it was IBM's profitability that enabled its full-employment policy. However, compensation research often attempts to answer questions of causality. Does the use of performance-based pay lead to greater customer satisfaction, improved quality, and better company performance? Causality is one of the most difficult questions to answer and continues to be an important and sometimes perplexing problem for researchers.

3. Are There Alternative Explanations?

Consider a hypothetical study that attempts to assess the impact of a performance-based pay initiative. The researchers measure performance by assessing quality, productivity, customer satisfaction, employee satisfaction, and the facility's performance. The final step is to see whether future performance improves over current performance. If it does, can we safely assume that it was the incentive pay that caused improved performance? Or is it equally likely that the improved performance has alternative explanations, such as the fluctuation in the value of currency, or perhaps a change in executive leadership in the facility? In this case, causal evidence seems weak.

If the researchers had measured the performance indicators several years prior to and after installing the plan, then the evidence of causality would be a bit stronger. Furthermore, if the researchers repeated this process in other facilities and found similar results, then the preponderance of evidence would be stronger. Clearly, the organization is doing something right, and incentive pay may be part of it.

The best way to establish causation is to account for these competing explanations, either statistically or through control groups. The point is that alternative explanations often exist. And if they do, they need to be accounted for in order to establish causality. It is very difficult to disentangle the effects of pay plans to clearly establish causality. However, it is possible to look at the overall pattern of evidence to make judgments about the effects of pay.

Conclusion

The model presented in this chapter provides a structure for understanding compensation systems. The three main components of the model include the objectives of the pay system, the policy decisions that provide the system's foundation, and the techniques that link policies and objectives. The following sections of the book examine each of the four policy decisions—internal alignment, external competitiveness, employee contributions, and administration—as well as techniques, new directions, and related research.

Two questions should constantly be in the minds of managers and readers of this text. First, Why do it this way? There is rarely one correct way to design a system or pay an individual.

Organizations, people, and circumstances are too varied. But a well-trained manager can select or design a suitable approach.

Second, So what? What does this technique do for us? How does it help achieve our organization goals? If good answers are not apparent, there is no point to the technique. Adapting the pay system to meet the needs of the employees and to help achieve the goals of the organization is what this book is all about.

The basic premise of this book is that compensation systems do have a profound impact. Yet, too often, traditional pay systems seem to be designed in response to some historic but long-forgotten problem. The practices continue, but the logic underlying them is not always clear or even relevant.

Chapter Summary

1. Compensation is used by society as a measure of justice, a cause of increased taxes and price increases. Stockholders are concerned with executive pay relative to company performance. Managers see compensation as a major expense and a means to influence employee behaviour. Employees see compensation as a return in an exchange with their employer, an entitlement, or a reward. In other countries, compensation relates to being taken care of.
2. The two major components of total returns for work are total compensation and relational returns. Total compensation is composed of cash compensation (base pay and incentives) and benefits. Relational returns include psychological aspects of work such as recognition and status, challenging work, and learning opportunities.
3. The four strategic policies in the pay model are internal alignment, external competitiveness, employee contributions, and administration. The internal structure techniques associated with alignment are work analysis, descriptions, and evaluation/certification. The pay structure techniques associated with competitiveness are market definitions, surveys, and pay policy lines. The incentive program techniques associated with contributions are seniority-based, performance-based, and merit guidelines. The evaluation techniques associated with administration are planning, budgeting, and communication.
4. The strategic objectives of compensation are (1) efficiency in performance and quality, satisfying customers and stockholders, and controlling costs, (2) fairness, and (3) compliance with laws and regulations.

Key Terms

Review Questions

1. How do differing perspectives affect our views of compensation?
2. How does the pay model help organize one's thinking about compensation?
3. What can a pay system do for an organization? For an employee? Are these mutually exclusive?

EXPERIENTIAL EXERCISES

1. What is your definition of compensation? Which meaning of compensation seems most appropriate from an employee's view – return, reward, or entitlement? Compare your ideas with someone who has more experience, with someone from another country, with someone from another field of study.

2. List all the forms of pay you receive from work. Compare to someone else's list. Explain any differences.

3. Answer the three questions in Caveat Emptor for any study or business article that tells you how to pay people. Such articles can be found in the *WorldatWork Journal* or *Compensation and Benefits Review*.

WEB EXERCISE

Compensation on the Web

The WorldAtWork Web site www.worldatwork.org provides information on its compensation-related journals and special publications, as well as short courses aimed at practitioners. The Canadian Council of Human Resource Associations (CCHRA) www.cchra-ccarh.ca provides links to provincial HR associations that offer compensation-related information as well as more general HRM information. Some provinces have job boards for HR association members, including students. Both sites are good sources of information for people interested in careers in HRM. The Employee Benefits Research Institute (EBRI) includes links to other benefits sources on its Web site at www.ebri.org. Using the WorldAtWork and EBRI sites as a starting point, search for a list of five or more compensation magazines and journals.

CASE

Inside Internships

Many students work as unpaid interns as they begin their careers. Jaime Hurlbut completed a one-year internship at the Canadian Youth Business Foundation. The internship was provided through Career Edge, a private organization that arranges youth internships. Jaime found that when he graduated from university, most jobs he wanted required two to three years of experience. His internship gave him the means to succeed, and he was hired full-time as a Marketing and Communications Coordinator at the Canadian Youth Business Foundation. Jaime's satisfaction is obvious. He says: "I am finally doing what I have always dreamed of."

Questions

1. What do employers receive from summer interns? What returns do students get from the opportunities?
2. Should summer interns be paid? If so, how much? How would you recommend an employer decide the answers to both these questions?
3. What added information would you like to have before you make your recommendations? How would you use this information?

Source: "Inside Internships" www.careeredge.ca/testimonials.asp?sequence=3 (June 11, 2003).