Part **One**

Introducing the Pay Model and Pay Strategy

Why do we work? If we are fortunate, our work brings meaning to our lives, challenges us in new and exciting ways, brings us recognition, and gives us the opportunity to interact with interesting people and create friendships. Oh yes—we also get a paycheck. Here in Part One of your book, we begin by talking about what we mean by "pay" and how paying people in different ways can influence them and, in turn, influence organization success. Wages and salaries, of course, are part of compensation, but so, too, for some employees are bonuses, health care benefits, stock options, and/or work-life balance programs.

Compensation is one of the most powerful tools organizations have to influence their employees. Managed well, it can play a major role in organizations successfully executing their strategies through their employees. Managed less well, as General Motors, Chrysler, and Bear Stearns, for example, learned, compensation decisions can also come back to haunt you. In Part One, we describe the compensation policies and techniques that organizations use and the multiple objectives (e.g., performance) they hope to achieve by effectively managing these compensation decisions.

Although compensation has its guiding principles, we will see that "the devil is in the details" and how any compensation program is specifically designed and implemented will help determine its success. We want you to bring a healthy skepticism when you encounter simplistic or sweeping claims about whether a particular way of managing compensation does or does not work. For example, organizations, in general, benefit from pay for performance, but there are many types of pay for performance programs and it is not always easy to design and implement a program that has the intended consequences (and avoids *unintended* consequences). So, general principles are helpful, but only to a point. Thus, in Part One, our aim is to also help you understand how compensation strategy decisions interact with the specific context of an organization (e.g., its business and human resource strategies) to influence organization success. We emphasize that good theory and research is fundamental to not only understanding compensation's likely effects, but also to developing that healthy skepticism we want you to have toward simplistic claims about what works and what does not.

Chapter **One**

The Pay Model

Chapter Outline

Money (That's What I Want)[1]

The best things in life are free
But you can keep them for the birds and bees
Chorus:

Now give me money
That's what I want
That's what I want, yeah
That's what I want

You're lovin' gives me a thrill
But you're lovin' don't pay my bills
[chorus]

Money don't get everything it's true
What it don't get, I can't use
[chorus]

COMPENSATION: DOES IT MATTER? (OR, "SO WHAT?")

Why should you care about compensation? Maybe because you and yours find that life goes more smoothly when there is at least as much money coming in as going out. (See the lyrics for "Money," above.) Maybe you would like to solve the mystery of why you or someone you know gets paid the way they do. Maybe you are curious, too, about people in the news and their pay. Why did Beyoncé earn $80 million one year, whereas Britney Spears earned $2.25 million?[2] Why did workers at General Motors get total compensation of about $60 per hour, whereas U.S. workers at Toyota received $48 per hour and the average total compensation per hour in U.S. manufacturing was $25 (and $16 in Korea, $3 in Mexico)? Why did Richard Anderson, chief executive at Delta earn $600,000, whereas Lawrence J. Ellison, chief executive at Oracle, earned about 1,000 times as much ($557 million)? Why did James Simons, a former math professor and now hedge fund manager, earn $2.5 billion? (Wow, professors can make that much money? Oh, "former" professor. OK.)

More important, does it matter how much and how these people get paid? We'll certainly talk about employee and executive pay in this book. (Maybe not so much about singers. Sorry.) Let's take a brief look at a few examples where pay does seem to have mattered.

General Motors (GM) has, for decades, paid its workers well—too well perhaps for what it received in return. So what? Well, in 1970, GM had 150 U.S. plants and 395,000 hourly workers. In sharp contrast, GM anticipates having only about 35 plants and 38,000 hourly workers in the very near future.[3] In June 2009, GM had to file for bankruptcy (avoiding it for a while thanks to loans from the U.S. government—i.e., you, the taxpayer). Not all of GM's problems were compensation related. Of course, building vehicles that consumers did not want was also a problem. But, having labor costs higher than the competition, without corresponding advantages in efficiency, quality, and customer service, does not seem to have served GM or its stakeholders well. Its stock price, which peaked at $93.62/share in April 2000, closed recently at below $1/share—about what it was during the Great Depression of the 1930s. Its market value was about $60 billion in 2000. Think of all the shareholder wealth that will be wiped out in bankruptcy. Think of the billions of dollars the U.S. taxpayer is putting into GM. Think of the hundreds of thousands of jobs that have been lost and the effects on communities that have lost those jobs.

On the other hand, Nucor Steel pays its workers very well relative to what other companies inside and outside of the steel industry pay. But Nucor also has much higher productivity than is typical in the steel industry. The result: Both the company and its workers do well.

Wall Street financial services firms and banks used **incentive** plans that rewarded people for developing "innovative" new financial investment vehicles and for taking risks to earn themselves and their firms a lot of money.[4] That is what happened—until recently. Then, the markets discovered that many such risks had gone bad. Blue Chip firms such as Lehman Brothers slid quickly into bankruptcy, whereas others like Bear Stearns and Merrill Lynch survived to varying degrees by finding other firms (J.P. Morgan and Bank of America, respectively) to buy them.

Would greater expertise in the design and execution of compensation plans have helped? Congress and the President seem to think so, because they have put into place new legislation, the Troubled Asset Relief Program (TARP), which includes restrictions on executive pay that are designed to discourage executives from taking "unnecessary and excessive risks" Another commentator agrees. In an opinion piece in the *Wall Street Journal,* entitled "How Business Schools Have Failed Business," the former Director of Corporate Finance Policy at the United States Treasury wrote that "misaligned incentive programs are at the core of what brought our financial system to its knees."[5] He says that we "should ask how many of the business schools attended by America's CEOs and directors educate their students about the best way to design managerial compensation systems." His answer: not many. Our book, we hope, can play a role in helping to better educate you, the reader, about the design of compensation systems, both for managers and for workers.

How people are paid affects their behaviors at work, which affect an organization's success.[6] For most employers, compensation is a major part of total cost, and often it is the single largest part of operating cost. These two facts together mean that well-designed compensation systems can help an organization achieve and sustain competitive advantage. On the other hand, as we have recently seen, poorly designed compensation systems can likewise play a major role in undermining organization success.

COMPENSATION: DEFINITION, PLEASE

How people view compensation affects how they behave. It does not mean the same thing to everyone. Your view probably differs, depending on whether you look at compensation from the perspective of a member of society, a stockholder, a manager, or an employee. Thus, we begin by recognizing different perspectives.

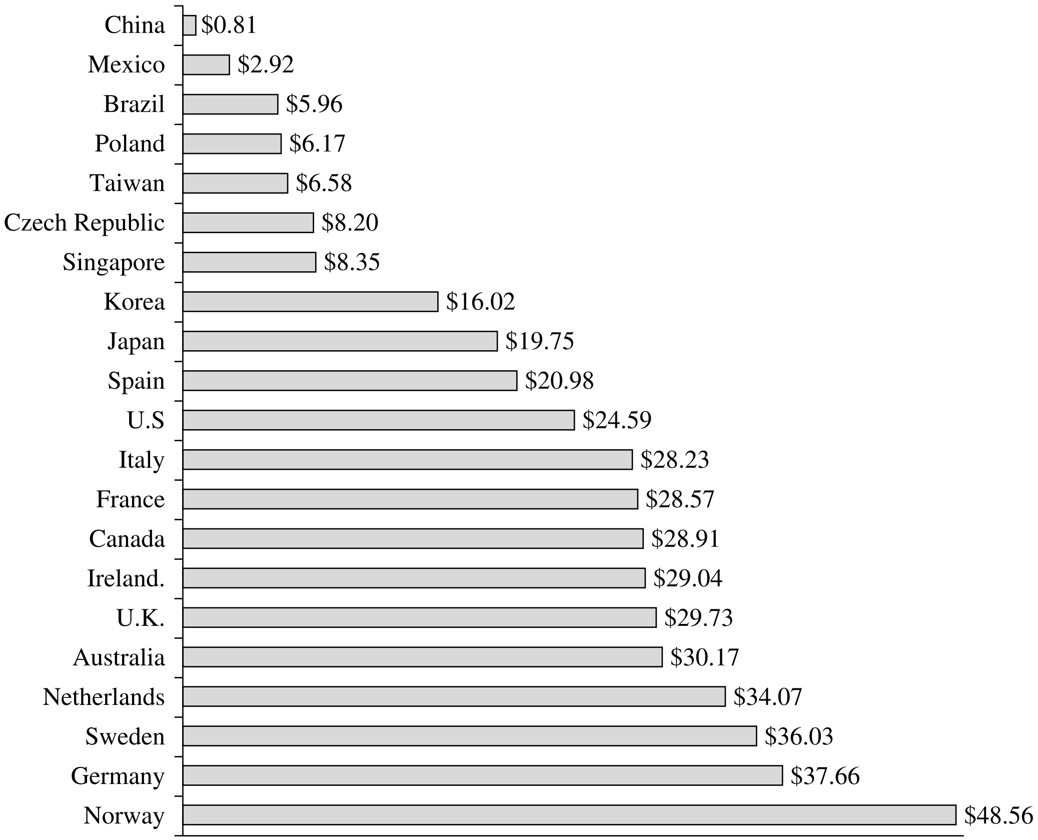
Society

Some people see pay as a measure of justice. For example, a comparison of earnings between men and women highlights what many consider inequities in pay decisions. In 2007, among full-time workers in the United States, women earned 80 percent of what men earned, up from 62 percent in 1979. If women had the same education, experience, and union coverage as men and also worked in the same industries and occupations, they would be expected to earn about 90 percent of what men earn. Society has taken an interest in such earnings differentials. One indicator of this interest is the introduction of laws and regulation aimed at eliminating the role of discrimination in causing them.[7] (See Chapter 17.)

Benefits given as part of a total compensation package may also be seen as a reflection of equity or justice in society. Individuals and businesses in the United States spend $2.2 trillion per year, or 16 percent of its economic output (gross domestic product) on health care.[8] Employers spend about 40 cents for benefits on top of every dollar paid for **wages** and **salaries.**[9] Wal-Mart reports that its health care costs have been growing faster than any other expense and that costs for care of employee spouses are far more expensive than costs for care of Wal-Mart employees. Nevertheless, roughly 46 million people in the United States (16 percent of the population) have no health insurance.[10] A major reason is that the great majority of people (who are under the age of 65 and not below the poverty line) obtain health insurance through their employers, but small employers, which account for a substantial share of employment, are much less likely than larger employers to offer health insurance to their employees. As a result, 8 in 10 of the uninsured in the United States are from working families.[11] Given that those who do have insurance typically have it through an employer, it also follows then that as the unemployment rate increases, health care coverage declines further. Some users of online dating services provide information on their employer-provided health care insurance. Dating service "shoppers" say they view health insurance coverage as a sign of how well a prospect is doing in a career.

Job losses (or gains) in a country over time are partly a function of relative labor costs (and productivity) across countries. People in the United States worry about losing manufacturing jobs to Mexico, China, and other nations. (Increasingly, white collar work in areas like finance, computer programming, and legal services is also being sent overseas.) Exhibit 1.1 reveals that the hourly wages for Mexican manufacturing

EXHIBIT 1.1 **Hourly Compensation Costs for Production Workers in Manufacturing (in U.S. Dollars)**



Source: Bureau of Labor Statistics News, March 26, 2009.

work ($2.92) are about 12 percent of those paid in the United States ($24.59). China's estimated $0.81 per hour is about 3 percent of the U.S. rate. However, the value of what is produced also needs to be considered. Productivity in China is about 6 percent of that of U.S. workers, whereas Mexican worker productivity is 22 percent of the U.S. level.[12] (We return to the topic of offshoring in Chapter 7.)

Some consumers know that pay increases often lead to price increases. They do not believe that higher labor costs benefit them. But other consumers lobby for higher wages. While partying revelers were collecting plastic beads at New Orleans' Mardi Gras, filmmakers were showing video clips of the Chinese factory that makes the beads. In the video, the plant manager describes the punishment (5 percent reduction in already low pay) that he metes out to the young workers for workplace infractions. After viewing the video, one reveler complained, "It kinda takes the fun out of it."[13]

Stockholders

Stockholders are also interested in how employees are paid. Some believe that using stock to pay employees creates a sense of ownership that will improve performance, which will, in turn, increase stockholder wealth. But others argue that granting employees too much ownership dilutes stockholder wealth. Google's stock plan cost the company $600 million in its first year of operation. So people who buy Google stock are betting that this $600 million will motivate employees to generate more than $600 million in extra revenue.[14]

Stockholders have a particular interest in executive pay. To the degree that the interests of executives are aligned with those of shareholders (e.g., by paying executives on the basis of company performance measures such as shareholder return), the hope is that company performance will be higher. There is debate, however, about whether executive pay and company performance are strongly linked in the typical U.S. company.[15] In the absence of such a linkage, concerns arise that executives can somehow use their influence to obtain high pay without necessarily performing well. Forbes compared the performance of the chief executive officer (CEO) at large U.S. firms to his/her compensation (see Exhibit 1.2). The idea, one might say, was to identify the CEOs who gave shareholders the "most (and least) bang for the buck."

Although the "best CEO for the buck" idea is interesting, the complex world of CEO pay means that things are not always so simple. Take, for example, the case of Jeffrey Bezos at Amazon, second on the Forbes list of best CEOs. Forbes reports his average annual compensation over 6 years as just over $1 million, modest for a CEO of a large firm. However, Forbes also reports that Bezos is a major shareholder, owning more than 20 percent of Amazon shares. In 2004 alone, Bezos sold 3.8 million shares, which generated over $157 million. So, to say that his income as a CEO was just over $1 million per year really does not tell the entire story. At the other extreme, Richard Fairbanks of Capital One Bank just barely missed making the Bottom Three in Exhibit 1.2. His average annual compensation over 6 years was $66.5 million. That is an awful lot of money to be sure, especially since average annual shareholder return over that same period was negative (−9%). However, Mr. Fairbanks took no base salary or bonus payments during that time period. Like Mr. Bezos, he made his money entirely through stock ownership (including by exercising options to buy stock and

EXHIBIT 1.2 **Bang for the Buck: CEO Compensation and Shareholder Return**

Name	Company	Firm Performance 6-Year Annual Total Shareholder Return (TSR)	Firm Performance Relative to Its Industry (Average TSR = 100)	6-Year Average CEO Compensation
Top Three				
Michael Bennett	Terra Indusries	64%	141	$3,550,000
Jeffrey Bezos	Amazon	21%	113	$1,020,000
John Wiehoff	CH Robinson Worldwide	21%	115	$4,920,000
Middle of the Pack				
Bruce Smith	Tesoro	28%	106	$15,100,000
Jerald Fishman	Analog Devices	−3%	107	$14,520,000
Ralph Lauren	Ralph Lauren Polo	4%	109	$18,770,000
Bottom Three				
Ramani Ayer	Hartford Financial	−17%	87	$13,540,000
Jeffrey Imelt	General Electric	−11%	85	$14,380,000
Kenneth Lewis	Bank of America	−16%	90	$29,670,000

Source: www.forbes.com, "CEO Compensation," April 22, 2009, extracted May 1, 2009.

then selling it). Consider that between year-end 1995 and year-end 2005, the Capital One stock price (adjusted for splits) went from $7.01/share to $81.18/share. That translated into an increase in shareholder value of roughly $20 billion. Roughly another $10 billion was created by year-end 2007. In other words, Mr. Fairbanks' "bang for the buck" depends on exactly what years are chosen for study. It is not clear that Capital One shareholders see Mr. Fairbanks as someone who has done poorly by them.

Managers

For managers, compensation influences their success in two ways. First, it is a major expense. Competitive pressures, both global and local, force managers to consider the affordability of their compensation decisions. Labor costs can account for more than 50 percent of total costs. In some industries, such as financial or professional services and in education and government, this figure is even higher. However, even within an industry, labor costs as a percent of total costs vary among individual firms. For example, small neighborhood grocery stores, with labor costs between 15 percent and 18 percent, have been driven out of business by supermarkets that delivered the same products at a lower cost of labor (9 percent to 12 percent). Supermarkets today are losing market share to the warehouse club stores such as Sam's Club and Costco, who enjoy an even lower cost of labor (4 percent to 6 percent), even though Costco pays above-average wages for the industry.

Exhibit 1.3 compares the hourly pay rate for retail workers at Costco to that at Wal-Mart and Sam's Club (which is owned by Wal-Mart). Each store tries to provide a unique shopping experience. Wal-Mart and Sam's Club compete on low prices,

EXHIBIT 1.3 Pay Rates at Retail Stores, Customer Satisfaction, Employee Turnover, and Sales per Square Foot

Sources: Liza Featherstone, "Wage Against the Machine," *Slate,* June 27, 2008; "Costco Outshines the Rest" and customer satisfaction data from Consumer Reports, May 2009; 2009 Costco and WalMart Annual Reports.

	Starting Pay	Pay After 4 Years	Customer Satisfaction (100 = highest)	Employee Annual Turnover	Store Size Average (sq. ft.)	Stores	Revenues	Revenue (per sq. ft.)
Costco	$11.00	$19.50	85	20%	141,000	555	$ 70,977,484,000	$907
Sam's Club	$10.00	$12.50	76	50%	133,000	602	$ 46,854,000,000	$585
Wal-Mart	$ 8.40	$10.50	68	50%	160,964	3,656	$401,244,000,000	$682

Notes: Separate turnover data unavailable for Sam's Club. Overall Wal-Mart turnover rate is thus used. Pay after 4 years rate unavailable for Wal-Mart. Its average pay rate is thus used.

with Sam's Club being a "warehouse store" with especially low prices on a narrower range of products, often times sold in bulk. Costco also competes on the basis of low prices, but with a mix that includes more high-end products aimed at a higher customer income segment. To compete in this segment, Costco appears to have chosen to pay higher wages, perhaps as a way to attract and retain a higher quality workforce.[16] Based on Exhibit 1.3, Costco is quite successful, relative to its competitors, in terms of employee retention, customer satisfaction, and the efficiency with which it generates sales (see revenure per square foot). So, although its labor costs are higher than those of Sam's Club and Wal-Mart, it appears that this model works for Costco because it helps gain an advantage over its competitors.

Thus, rather than treating pay only as an expense to be minimized, a manager can also use it to influence employee behaviors and to improve the organization's performance. As our Costco (versus Sam's Club and Wal-Mart) example seems to suggest, the way people are paid affects the quality of their work and their attitude toward customers.[17] It may also affect their willingness to be flexible, learn new skills, or suggest innovations. On the other hand, people may become interested in unions or legal action against their employer based on how they are paid. This potential to influence employees' behaviors, and subsequently the productivity and effectiveness of the organization, means that the study of compensation is well worth your time, don't you think?[18]

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.[19]

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 continue to use that term, no one says, "They just gave me a reward increase," or "Here is my weekly reward." Yet if people see their pay as a return for their efforts rather than as a reward, and if writers and consultants persist in trying to convince managers that pay is a reward for employees, this disconnect may mislead 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.

Incentive and Sorting Effects of Pay on Employers' Behaviors

Pay can influence employee **motivation** and behavior in two ways. First, and perhaps most obvious, pay can affect the motivational intensity, direction, and persistence of current employees. Motivation, together with employee **ability** and work/organizational design (which can help or hinder employee performance), determines employee behaviors such as performance. We will refer to this effect of pay as an **incentive effect,** the degree to which pay influences individual and aggregate motivation among the employees we have at any point in time.

However, pay can also have an indirect, but important, influence via a **sorting effect** on the composition of the workforce.[20] That is, different types of pay strategies may cause different types of people to apply to and stay with (i.e., self-select into) an organization. In the case of pay structure/level, it may be that higher pay levels help organizations to attract more high-quality applicants, allowing them to be more selective in their hiring. Similarly, higher pay levels may improve employee retention. (In Chapter 7, we will talk about when paying more is most likely to be worth the higher costs.)

Less obvious perhaps, it is not only how much, but *how* an organization pays that can result in sorting effects.[21] Ask yourself: Would people who are highly capable and have a strong work ethic and interest in earning a lot of money prefer to work in an organization that pays employees doing the same job more or less the same amount, regardless of their performance? Or, would they prefer to work in an organization where their pay can be much higher (or lower) depending on how they perform? If you chose the latter answer, then you believe that sorting effects matter. People differ regarding which type of pay arrangement they prefer. The question for organizations is simply this: Are you using the pay policy that will attract and retain the types of employees you want?

Let's take a look at one especially informative study.[22] Individual worker productivity was measured before and after a glass installation company switched one of its plants from a salary-only (no pay for performance) system to an individual incentive plan under which each employee's pay depended on his/her own performance. An overall increase in plant productivity of 44% was observed comparing before and after. Roughly one-half of this increase was due to individual employees becoming more productive. However, the remaining one-half of the productivity gain was not explained by this fact. So, where did the other one-half of the gain come from? The answer: Less productive workers were less likely to stay under the new individual incentive system because it was less favorable to them. When they left, they tended to be replaced by more productive workers (who were happy to have the chance to make more money than they might make elsewhere). Thus, focusing only on the incentive effects of pay (on current workers) can miss the other major mechanism (sorting) by which pay decisions influence employee behaviors.

The pay model that comes later in this chapter includes compensation policies and the **objectives** (efficiency, fairness, compliance) these are meant to influence. Our point here is that compensation policies work through employee incentive and sorting effects to either achieve or not achieve those objectives.

Global Views—*Vive la différence*

In English, *compensation* means something that counterbalances, offsets, or makes up for something else. However, if we look at the origin of the word in different languages, we get a sense of the richness of the meaning, which combines entitlement, return, and reward.[23]

In China, the traditional characters for the word "compensation" are based on the symbols for logs and water; compensation provides the necessities in life. In the recent past, the state owned all enterprises and compensation was treated as an entitlement. In today's China, compensation takes on a more subtle meaning. A new word, *dai yu,* is used. It refers to how you are being treated—your wages, benefits, training opportunities, and so on. When people talk about compensation, they ask each other about the *dai yu* in their companies. Rather than assuming that everyone is entitled to the same treatment, the meaning of compensation now includes a broader sense of returns as well as entitlement.[24]

"Compensation" in Japanese is *kyuyo,* which is made up of two separate characters (*kyu* and *yo*), both meaning "giving something." *Kyu* is an honorific 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 with the family, housing, and commuting allowances that are still used in many Japanese companies.[25]

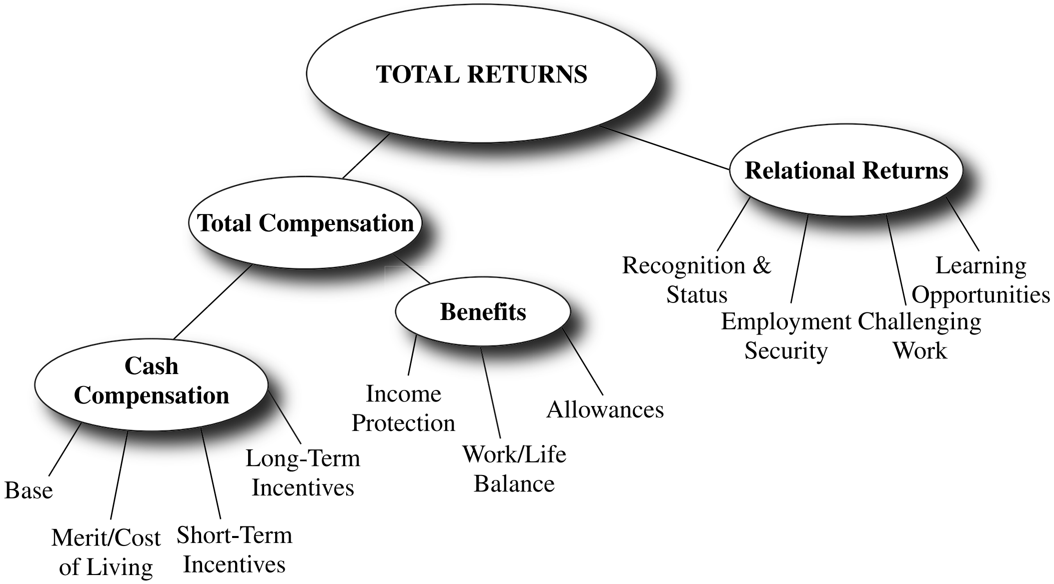
These contrasting ideas about compensation—multiple views (societal, stockholder, managerial, employee, and even global) and multiple meanings (returns, rewards, entitlement)—add richness to the topic. But they can also cause confusion unless everyone is talking about the same thing. So let's define what we mean by "compensation" or "pay" (the words are used interchangeably in this book):

> **Compensation** refers to all forms of financial returns and tangible services and benefits employees receive as part of an employment relationship.

FORMS OF PAY

Exhibit 1.4 shows the variety of returns people receive from work. They are categorized as **total compensation** and **relational returns.** The relational returns (learning opportunities, status, challenging work, and so on) are psychological.[26]

EXHIBIT 1.4 **Total Returns for Work**



Total compensation returns are more transactional. They include 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, brightly colored uniforms).[27] So pay comes in different forms, and programs to pay people can be designed in a wide variety of ways. WorldatWork has a Total Rewards Model that is similar and includes compensation, benefits, work-life, performance/recognition, and development/career opportunities.[28]

Cash Compensation: Base

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 $20 an hour. However, some individual operators may receive more because of their experience and/or performance. Some pay systems set base wage as a function of the skill or education an employee possesses; this is common for engineers and schoolteachers.[29]

A distinction is often made in the United States between wage and salary, with **salary** referring to pay for employees who are **exempt** from regulations of the Fair Labor Standards Act (FLSA) and hence do not receive overtime pay.[30] Managers and professionals usually fit this category. Their pay is calculated at an annual or monthly rate rather than hourly, because hours worked do not need to be recorded. In contrast, workers who are covered by overtime and reporting provisions of the Fair Labor Standards Act—*nonexempts*—have their pay calculated as an hourly wage. Some organizations, such as IBM, Eaton, and Wal-Mart, label all base pay as "salary." Rather than dividing employees into separate categories of salaried and wage earners, they believe that an "all-salaried" workforce reinforces an organizational **culture** in which all employees are part of the same team. However, merely changing the terminology does not negate the need to comply with the FLSA.

Cash Compensation: Merit Pay/Cost-of-Living Adjustments

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

Merit increases are given as increments to the base pay in recognition of *past* work behavior.[31] According to surveys, 90 percent of U.S. firms use merit pay increases.[32] 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 a 6 to 8 percent merit increase 8 months after their last increase, whereas an average performer may receive, say, a 3 to 4 percent increase after 12 or 15 months. In contrast to merit pay, *cost-of-living adjustments* give the same increases to everyone, regardless of performance.

Cash Compensation: Incentives

Incentives tie pay increases directly to performance.[33] 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 will generally be known beforehand. Whereas merit pay programs evaluate past performance of an individual and then decide on the size of the increase, what must happen in order to receive the incentive payment is called out very specifically ahead of time. For example, a Toyota salesperson knows the **commission** on a Land Cruiser versus a Prius prior to making the sale. The larger commission he or she will earn by selling the Land Cruiser is the incentive to sell a customer that car rather then the Prius. Although both merit pay and incentives try to influence performance, incentives try to influence future behavior whereas merit recognizes (rewards) past behavior. The incentive-reward 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, increase in stock value—the possibilities are endless. Prax Air, for example, uses return on capital (ROC). For every quarter that a 6 percent ROC target is met or exceeded, Prax Air awards bonus days of pay. An 8.6 percent ROC means 2 extra days of pay for that quarter for every employee covered by the program. An ROC of 15 percent means 8.5 extra days of pay.

Because incentives are one-time payments, they do not permanently increase labor 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 multiyear results. Typically they are in the form of stock ownership or options to buy stock at specified, advantageous prices. The belief underlying stock ownership is that employees with a financial stake in the organization will focus on long-term financial objectives: return on investment, market share, return on net assets, and the like. Bristol-Myers Squibb grants stock to selected "Key Contributors" who make outstanding contributions to the firm's success. Stock options are often the largest component in an executive pay package. Some companies extend stock ownership beyond the ranks of managers and professionals. Sun Microsystems, Intel, Google, and Starbucks offer stock options to all their employees.[34]

Benefits: Income Protection

Exhibit 1.4 showed that benefits, including income protection, work/life services, and allowances, are also part of total compensation. Some income protection programs are legally required in the United States; employers must pay into a fund that provides income replacement for workers who become disabled or unemployed. Employers also make half the contributions to Social Security. (Employees pay the other half.) Different countries have different lists of mandatory benefits.

Medical insurance, retirement programs, life insurance, and savings plans 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. The cost of providing benefits has been rising. For example, in the U.S. employers pay nearly half the nation's health care bills, and health care expenditures have recently been increasing at annual rates around 15 to 20 percent. Many employers are trying to change or decrease the benefits they offer. General Motors recently bought out over 35,000 employees by paying them incentives ranging from $35,000 to $140,000 to retire and keep their pensions but drop their medical coverage.[35] GM spends so much for benefits that it has been called a pension and health care provider that also makes cars.

Benefits: Work/Life Balance

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 counseling, financial planning, referrals for child and elder care), and flexible work arrangements (telecommuting, nontraditional schedules, nonpaid time off). Responding to the changing demographics of the workforce (two-income families or single parents who need work-schedule flexibility so that family obligations can be met), many U.S. employers are giving a higher priority to these benefit forms. Medtronic, for example, touts its Total Well-Being Program that seeks to provide "resources for growth—mind, body, heart, and spirit" for each employee. Health and wellness, financial rewards and security, individual and family well-being, and a fulfilling work environment are part of this "total well-being."[36] Medtronic believes that this program permits employees to be "fully present" at work and less distracted by conflicts between their work and nonwork responsibilities.

Benefits: Allowances

Allowances often grow out of whatever is in short supply. In Vietnam and China, housing (dormitories and apartments) and transportation allowances are frequently part of the pay package. Sixty years after the end of World War II–induced food shortages, some Japanese companies still continue to offer a "rice allowance" based on the number of an employee's dependents. Almost all foreign companies in China discover that housing, transportation, and other allowances are expected.[37] Companies that resist these allowances must come up with other ways to attract and retain employees. In many European countries, managers assume that a car will be provided—only the make and model are negotiable.[38]

Total Earnings Opportunities: Present Value of a Stream of Earnings

Up to this point we have treated compensation as something received at a moment in time. But a fiirm's compensation decisions have a temporal effect. Say you have a job offer of $50,000. If you stay with the firm 5 years and receive an annual increase of 4 percent, in 5 years you will be earning $60,833 a year. For your employer, the five-year cost commitment of the decision to hire you turns out to be $331,649 in cash. If you add in an additional 25 percent for benefits, the decision to hire you implies a commitment of over $400,000 from your employer. Will you be worth it? You will be after this course.

A present-value perspective shifts the comparison of today's initial offers to consideration of future bonuses, merit increases, and promotions. Sometimes a company will tell applicants that its relatively low starting offers will be overcome by larger future pay increases. In effect, the company is selling the present value of the future stream of earnings. But few candidates apply that same analysis to calculate the future increases required to offset the lower initial offers. Hopefully, everyone who reads Chapter 1 will now do so.

Relational Returns From Work

Why do Google millionaires continue to show up for work every morning? Why does Andy Borowitz write the funniest satirical news site on the web (*www.borowitzreport.com*) for free? There is no doubt that nonfinancial returns from work have a substantial effect on employees' behavior.[39] Exhibit 1.4 includes such relational returns from work as recognition and status, employment security, challenging work, and opportunities to learn. Other forms of relational return might include personal satisfaction from successfully facing new challenges, teaming with great co-workers, receiving new uniforms, and the like.[40] Such factors are part of the total return, which is a broader umbrella than total compensation.

The Organization as a Network of Returns

Sometimes it is useful to think of an organization as a network of returns created by all these different forms of pay, including total compensation and relational returns. The challenge is to design this network so that it helps the organization to succeed. As in the case of rowers pulling on their oars, success is more likely if all are pulling in unison rather than working against one another. In the same way, the network of returns is more likely to be useful if bonuses, development opportunities, and promotions all work together.

So the next time you walk in an employer's door, look beyond the cash and health care offered to search for all the returns that create the network. Even though this book focuses on compensation, let's not forget that compensation is only one of many factors affecting people's decisions about work, as songwriter Roger Miller made clear in this 1960s tune:

> Got a letter just this morning, it was postmarked Omaha.
> It was typed and neatly written offering me a better job,
> Better job and higher wages, expenses paid, and a car.
> But I'm on TV here locally, and I can't quit, I'm a star.
> . . . I'm the number one attraction in every supermarket parking lot.
> I'm the king of Kansas City. No thanks, Omaha, thanks a lot.
> Kansas City Star, that's what I are . . .

Lest you think that even your parents aren't old enough to remember the 1960s, Chely Wright more recently sang,

> Oh I love what I do
> But I wonder what I do it all for
> But when I sing, they sing along . . .
> The reason why I'm standing here
> It's not the miles
> It's not the pay
> It's not the show
> It's not the fame that makes this home
> It's the song.[41]

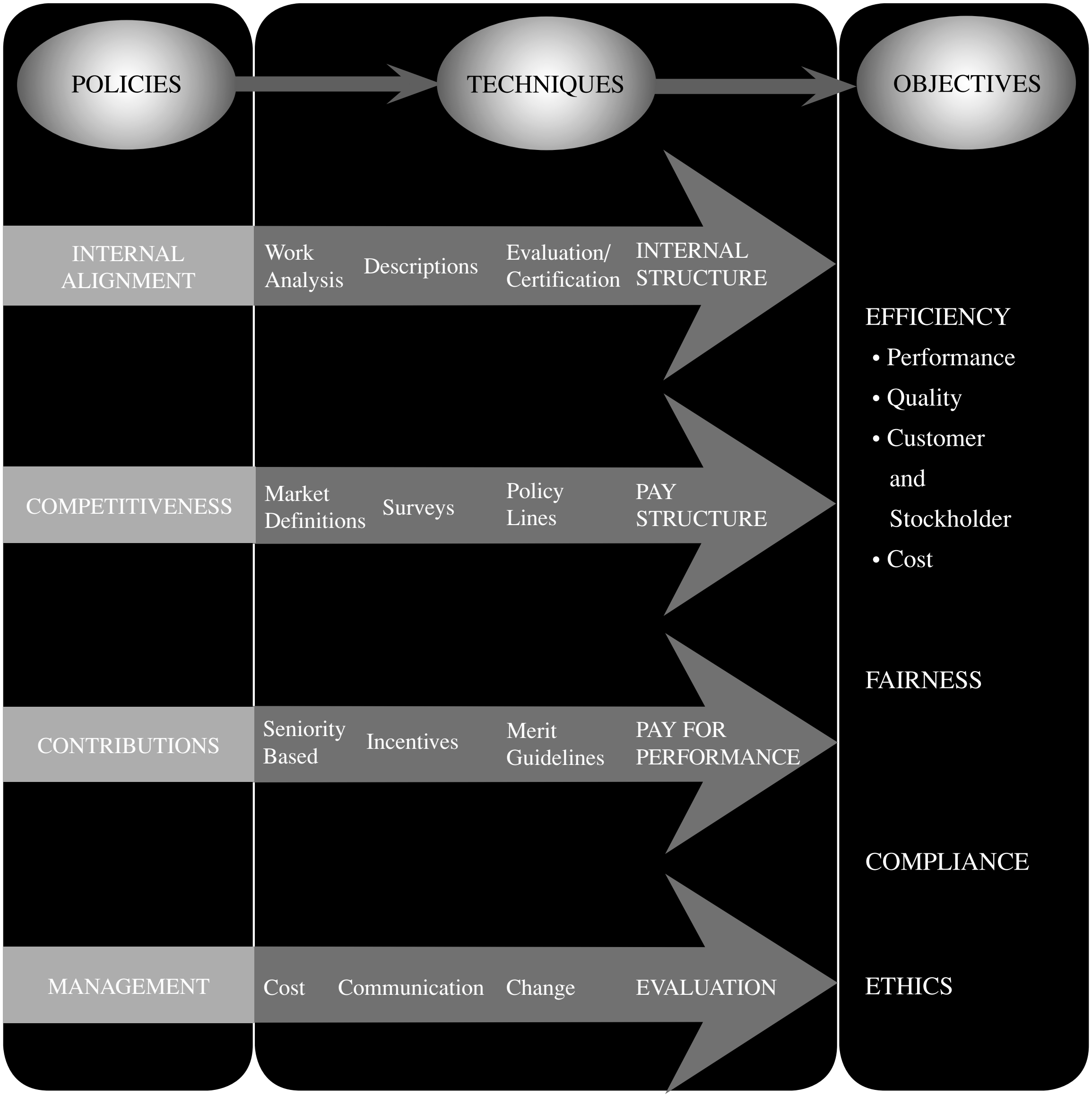
A PAY MODEL

The pay model shown in Exhibit 1.5 serves as both a framework for examining current pay systems and a guide for most of this book. It contains three basic building blocks: (1) the compensation objectives, (2) the policies that form the foundation of the compensation system, and (3) the techniques that make up the compensation system. Because objectives drive the system, we will discuss them first.

Compensation Objectives

Pay systems are designed to achieve certain objectives. The basic objectives, shown at the right side of the model, include efficiency, fairness, ethics, and compliance with laws and regulations. *Efficiency* can be stated more specifically: (1) improving performance, increasing quality, delighting customers and stockholders, and (2) controlling labor costs.

EXHIBIT 1.5 The Pay Model



Compensation objectives at Medtronic and Whole Foods are contrasted in Exhibit 1.6 Medtronic is a medical technology company that pioneered cardiac pacemakers. Its compensation objectives emphasize performance, business success, minimizing fixed costs, and attracting and energizing top talent.

Whole Foods is the nation's largest organic- and natural-foods grocer. Its markets are a "celebration of food": bright, well-stocked, and well-staffed.[42] The company describes its

EXHIBIT 1.6 Pay Objectives at Medtronic and Whole Foods

Medtronic	Whole Foods
Support Medtronic mission and increased complexity of business Minimize increases in fixed costs Attract and engage top talent Emphasize personal, team, and Medtronic performance Recognize personal and family total well-being Ensure fair treatment	We are committed to increasing long-term shareholder value. Profits are earned every day through voluntary exchange with our customers. Profits are essential to create capital for growth, prosperity, opportunity, job satisfaction, and job security. Support team member happiness and excellence We share together in our collective fate.

commitment to offering the highest quality and least processed foods as a shared responsibility. Its first compensation objective is ". . . committed to increasing shareholder value."

Fairness is a fundamental objective of pay systems.[43] In Medtronic's objectives, fairness means "ensure fair treatment" and "recognize personal and family well-being." Whole Foods's pay objectives discuss a "shared fate." In their egalitarian work culture, pay beyond base wages is linked to team performance, and employees have some say about who is on their team.

The fairness objective calls for 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* refers to the process used to make pay decisions.[44] It suggests that the way a pay decision is made may be equally as important to employees as the results of the decision.

Compliance as a pay objective means conforming to federal and state compensation laws and regulations. If laws change, pay systems may need to change, too, to ensure continued compliance. As companies go global, they must comply with the laws of all the countries in which they operate.

Ethics

Asian philosophy gives us the concept of yin and yang—complementary opposites rather than substitutes or trade-offs. It is not yin *or* yang; part of yin is in yang, and part of yang is in yin. So it is with objectives in the pay model. It is not efficiency versus fairness versus compliance. Rather, it is all three simultaneously. All three must be achieved. The tension of working toward all objectives at once creates fertile grounds for ethical dilemmas.

Ethics means the organization cares about how its results are achieved.[45] Scan the Web sites or lobby walls of corporate headquarters and you will inevitably find statements of "Key Behaviors," "Our Values," and "Codes of Conduct." One company's code of conduct is shown in Exhibit 1.7. The challenge is to put these statements into daily practice. The company in the exhibit is the formerly admired, now reviled, Enron, whose employees lost their jobs and pensions in the wake of legal and ethical misdeeds by those at the top.

Because it is so important, it is inevitable that managing pay sometimes creates ethical dilemmas. Manipulating results to ensure executive bonus payouts, misusing (or failing to understand) statistics used to measure competitors' pay rates, re-pricing or backdating stock options to increase their value, encouraging employees to invest a

EXHIBIT 1.7 Enron's Ethics Statement

Foreword

"As officers and employees of Enron Corp., its subsidiaries, and its affiliated companies, we are responsible for conducting the business affairs of the companies in accordance with all applicable laws and in a moral and honest manner. . . . We want to be proud of Enron and to know that it enjoys a reputation for fairness and honesty and that it is respected. . . . Enron's reputation finally depends on its people, on you and me. Let's keep that reputation high."

July 1, 2000
Kenneth L. Lay
Chairman and Chief Executive Officer

Values

Respect	We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness, and arrogance don't belong here.
Integrity	We work with customers and prospects openly, honestly, and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.
Communication	We have an obligation to communicate. Here, we take the time to talk with one another . . . and to listen.
Excellence	We are satisfied with nothing less than the very best in everything we do. . . . The great fun here will be for all of us to discover just how good we can really be.

Source: *www.thesmokinggun.com.*

portion of their wages in company stock while executives are bailing out, offering just enough pay to get a new hire in the door while ignoring the relationship to co-workers' pay, and shaving the hours recorded in employees' time card—these are all too common examples of ethical lapses.

Some, but not all, compensation professionals and consultants remain silent during ethical misconduct and outright malfeasance. Absent a professional code, compensation managers must look to their own ethics—and the pay model, which calls for combining the objectives of efficiency and fair treatment of employees as well as compliance.[46]

There are probably as many statements of pay objectives as there are employers. In fact, highly diversified firms such as General Electric and Eaton, which operate in multiple lines of businesses, may have different **pay objectives** for different business units. At General Electric, each unit's objectives must meet GE overall objectives.

Objectives serve several purposes. First, they guide the design of the pay system. If an objective is to increase customer satisfaction, then incentive programs and merit pay might be used to pay for performance. Another employer's objective may be to develop innovative new products. Job design, training, and team building may be used to reach this objective. The pay system aligned with this objective may include salaries that are at least equal to those of competitors (external competitiveness) and that go up with increased skills or knowledge (internal alignment). This pay system could be very different from our first example, where the focus is on increasing customer satisfaction. Notice that policies and techniques are the means to reach the objectives.

In summary, objectives guide the design of pay systems. They 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 skilled employees, but they are leaving for higher-paying jobs elsewhere, the system may not be performing effectively. Although there may be many nonpay reasons for such turnover, objectives provide standards for evaluating the effectiveness of a pay system.[47]

Four Policy Choices

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

Internal Alignment

Internal alignment refers to comparisons among 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 business 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 solutions for customers and satisfied stockholders more than another? What about two marketing managers working in different business units of the same organization? Internal alignment pertains 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. Whole Foods tries to manage differences with a salary cap that limits the **total cash** compensation (wages plus bonuses) of any executive to 19 times the average cash compensation of all full-time employees. The cap originally started at 8 times the average. However, attraction and retention problems were cited as a need for raising the cap several times since. (Note that the cap does not include stock options.)

Pay relationships within the organization affect all three compensation objectives. They 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, internal pay relationships indirectly affect the capabilities of the workforce and hence the efficiency of the entire organization. Fairness is affected through employees' comparisons of their pay to the pay of others in the organization. Compliance is affected by the basis used to make internal comparisons. Paying on the basis of race, gender, age, or national origin is illegal in the United States.

External Competitiveness

External competitiveness refers to pay comparisons with competitors. *How much* do we wish to pay in comparison to what other employers pay?

Many organizations claim their pay systems are market-driven, that is, based almost exclusively on what competitors pay. "Market driven" gets translated into practice in different ways.[48] 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. And what is the appropriate market? When, for example, should international pay rates be considered? Should the pay of software engineers in New Delhi or Minsk influence pay for engineers in Silicon Valley or Boston?

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 labor costs so that the organization's prices of products or services can remain competitive in a global economy.

Employee Contributions

How much emphasis should there be on paying for performance? Should one programmer be paid differently from another if one has better performance and/or greater seniority? Or should there be a **flat rate** for programmers? Should the company share any profits with employees? Share with all employees, part-time as well as full-time?

The emphasis to place on **employee contributions** (or nature of **pay mix**) is an important policy decision since it directly affects employees' attitudes and work behaviors. Eaton and Motorola use pay to support other "high-performance" practices in their workplaces.[49] Both use team-based pay and corporate profit-sharing plans. Starbucks emphasizes stock options and sharing the success of corporate performance with the employees. General Electric uses different performance-based pay programs at the individual, division, and companywide level. Performance-based pay affects fairness in that employees need to understand the basis for judging performance in order to believe that their pay is fair.

What mix of pay forms—base, incentives, stock, benefits—do our competitors use in comparison to the pay mix we use? Recall that Sam's Club's policy is to pay competitively in its market. Whole Foods combines base pay and **team incentives** to offer higher pay if team performance warrants. Medtronic sets its base pay to match its competitors but ties bonuses to performance. It offers stock to all its employees based on overall company performance.[50] Further, Medtronic believes that its benefits, particularly its emphasis on programs that balance work and life, make it a highly attractive place to work. It believes that *how* its pay is positioned and *what forms* it uses create an advantage over competitors.

The external competiveness and employee contribution decisions should be made jointly. Clearly, an above-market compensation level is most effective and sustainable when it exists together with above-market employee contributions to productivity, quality, customer service, or other important strategic objectives.

Management

A policy regarding management of the pay system is the last building block in our model. Management means ensuring that the *right people* get the *right pay* for *achieving the right objectives in the right way*. The greatest system design in the world is useless without competent management.

Managing compensation means answering the "So What" question. So what is the impact of this policy, this technique, this decision? Although it is possible to design a system that is based on internal alignment, external competitiveness, and employee contributions, what difference does it make? Does the decision help the organization achieve its objectives?[51]

The ground under compensation management has shifted. The traditional focus on how to administer various techniques is long gone, replaced by more strategic thinking—managing pay as part of the business. It goes beyond simply managing pay as an expense to better understanding and analyzing the impact of pay decisions on people's behaviors and organizations' success. The impact of pay decisions on expenses is one result that is easily measured and well understood. But other measures—such as pay's impact on attracting and retaining the right people, and engaging these people productively—are not yet widely used in the management of compensation. Efforts to do so are increasing and the perspective is shifting from "How To" toward trying to answer the "So What" question.[52] Ease of measurement is not the same as importance; costs are easy to measure (and, of course, important), so there is a tendency to focus there. Yet, the consequences of pay, although often less amenable to measurement, are nonetheless just as important.

Pay Techniques

The remaining portion of the pay model in Exhibit 1.5 shows the techniques that make up the pay system. 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.

Uncounted variations in **pay techniques** exist; many are examined in this book. Most consultant firms tout their surveys and techniques on their Web pages. You can obtain updated information on various practices by simply surfing the Web.

Cybercomp

World at Work (*www.worldatwork.org*) provides information on its compensation-related journals and special publications, as well as short courses aimed at practitioners. The Society of Human Resource Management (*www.shrm.org*) also offers compensation-related information as well as more general human resource management (HRM) information. The society's student services section offers guidance on finding jobs in the field of human resources. Both sites are good sources of information for people interested in careers in HRM. Information on pay trends in Europe is available from the European Industrial Relations Observatory (*www.eiro.eurofound.ie*). The International Labour Organization (www.ilo.org) maintains a database that can be browsed either by subject (conditions of employment) or country (*www.ilo.org/dyn/natlex/natlex_browse.home*). Over 2,000 articles are listed in their "wages" subheading, including such information as the minimum wage in Vanuatu. Cornell University's Industrial and Labor Relations School offers a "research portal" for articles of interest in human resource management (*www.ilr.cornell.edu/library/research/researchPortal.html*).The Employee Benefits Research Institute (EBRI) includes links to other benefits sources on its Web site (*www.ebri.org*). Every chapter in this book also mentions interesting Web sites. Use them as a starting point to search out others.

BOOK PLAN

Compensation is such a broad and compelling topic that several books are devoted to it. The focus of this book is on the design and management of compensation systems. To aid in understanding how and why pay systems work, our pay model provides the structure for much of the book. Chapter 2 discusses how to formulate and execute 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.[53]

The pay model plays a central role in formulating and implementing an organization's pay strategy. The model identifies four basic policy choices that are the core of the pay strategy. After we discuss strategy, the next sections of the book examine each of these policies in detail. Part 1 on *internal alignment* (Chapters 3 through 6) examines pay relationships within a single organization. Part 2 (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? These are questions of *employee contributions,* the third building block in the model, covered in Part 3 (Chapters 9 through 11).

In Part 4, we cover employee services and benefits (Chapters 12 and 13). How do benefits fit in the company's overall compensation package? What choices should employees have in their benefits? In Part 5, we cover systems tailored for special groups—sales representatives, executives, contract workers, unions (Chapters 14 and 15)—and we provide more detail on global compensation systems (Chapter 16). Part 6 concludes with information essential for *managing the compensation system.* The government's role in compensation is examined in Chapter 17. Chapter 18 includes understanding, communicating, budgeting, and evaluating results.

Even though the book is divided into sections that reflect the pay model, pay decisions are not discrete. All of them are interrelated. Together, they influence employee behaviors and organization performance and can create a pay system that can be a source of competitive advantage.

Throughout the book our intention is to examine alternative approaches. We believe that rarely is there 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 become better informed about these options, how to evaluate and select the most effective ones, and how to design new ones. Whether as an employee, a manager, or an interested member of society, you should be able to assess the effectiveness and fairness of pay systems.

CAVEAT EMPTOR—BE AN INFORMED CONSUMER

Most managers do not read research. They do not subscribe to research journals; they find them too full of jargon and esoterica, and they see them as impractical and irrelevant.[54] However, a study of 5,000 HR managers compared their beliefs to the research evidence in several areas and identified seven common and important misconceptions held by managers.[55] The study authors concluded that being unaware of key research findings may prove costly to organizations. For example, when it comes to motivating workers, organization efforts may be somewhat misguided if they do not know that "Money is the crucial incentive . . . no other incentive or motivational technique comes even close to money with respect to its instrumental value."[56]

So it pays to read the research. There is no question that some studies are irrelevant and poorly performed. But if you are not a reader of research literature, you become prey for the latest business self-help fad. Belief, even enthusiasm, is a poor substitute for informed judgment. Therefore, we end the chapter with a consumer's guide to research that includes three questions to help make you a critical reader—and a better-informed decision maker.

1. Is the Research Useful?

How useful are the variables in the study? How well are they measured? For example, many studies purport to measure organization performance. However, performance may be accounting measures such as return on assets or cash flow, financial measures such as earnings per share, operational measures such as scrap rates or defect indicators, or qualitative measures such as customer satisfaction. It may even be the opinions of compensation managers, as in, "How effective is your gain-sharing plan?" (Answer choices are "highly effective," "effective," "somewhat," "disappointing," "not very effective." "Disastrous" is not usually one of the choices.) The informed consumer must ask, Does this research measure anything useful?

2. Does the Study Separate Correlation From Causation?

Once we are confident that the variables are useful and accurately measured, we must be sure that they are actually related. Most often this is addressed through the use of statistical analysis. The **correlation coefficient** is a common measure of association and 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 related 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.

But even if there is a relationship, correlation does not ensure 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. Perhaps new technology, **reengineering,** improved marketing, or the general expansion of the local economy underlies the results. 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 do 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. IBM provides an example of the difficulty of deciding whether a change is a cause or an effect. Years ago, IBM pursued a no-layoff policy. History clearly reveals that the policy did not improve IBM's profitability or increase its stockholders' returns. Arguably, it was IBM's profitability that enabled its full-employment policy. However, compensation research often does attempt to answer questions of causality. How does the use of performance-based pay influence customer satisfaction, product quality, and company performance? Causality is one of the most difficult questions to answer and continues to be an important and sometimes perplexing problem for researchers.[57]

3. Are There Alternative Explanations?

Consider a hypothetical study that attempts to assess the impact of a performance-based pay program. 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 periods' performance improves over this period's. If it does, can we safely assume that it was the incentive pay that caused 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 leadership in the facility?

In this case, causality evidence seems weak. Alternative explanations exist. If the researchers had measured the performance indicators several years prior to and after installing the plan, then the evidence of causality is only a bit stronger. Further, if the researchers repeated this process in other facilities and the results were similar, then the preponderance of evidence is stronger yet. Clearly, the organization is doing something right, and incentive pay is part of it.

The best way to establish causation is to account for 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 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.

So we encourage you to become a critical reader of all management literature, including this book. As Hogwarts' famous Professor Alaster Moody cautions, be on "constant vigilance for sloppy analysis masquerading as research."[58]

Your **Turn** — Circuit City

In 2007, Circuit City fired 3,400 of its highest-paid store employees and began to replace them with lower-paid workers in hopes of reducing labor costs. In the following quarter, Circuit City reported that the company lost money. Some commentators attributed the loss to the fact that Circuit City had gotten rid of many of its most experienced and highly trained employees, which they believed translated into a poorer customer experience and, in turn, lower revenues and profits. According to *BusinessWeek,* "In the world of pricey consumer electronics, where customer service is arguably as important as quality products, Circuit City Stores is missing the mark and further eroding its profits."

However, a company spokesman said that only a few salespeople per store were affected by the workforce reductions and that many of the employees affected worked as customer service representatives or in the warehouses. As such, he questioned whether the cuts had significantly affected the in-store customer experience and thus whether the cuts had caused the decline in the company's performance.

Eventually, the bottom fell out of Circuit City's profits and stock price and it had to liquidate, closing its over 500 stores (resulting in over 30,000 employees losing their jobs).

Thinking back to our discussion in the chapter section, *Caveat Emptor*—Be An Informed Consumer, evaluate whether the replacement of highly paid workers with lower-paid workers did or did not cause Circuit City to perform so poorly. How confident are you in your evaluation? Why?

Perhaps the following data will be helpful. You might enjoy graphing the stock prices by year. You may wish to consider whether other data or information would be helpful in assessing Circuit City's change in compensation strategy.

Year	**Circuit City Year Opening Stock Price**	**Circuit City Customer Satisfaction (ASCI Index)**	**Best Buy Year Opening Stock Price**	**Best Buy Customer Satisfaction (ASCI Index)**
2000	48.00		25.89	
2001	16.06		17.75	
2002	28.51		32.31	
2003	7.22		18.27	
2004	8.95	73	36.00	72
2005	13.63	72	36.77	72
2006	22.94	70	47.05	71
2007	19.29	69	50.00	76
2008	4.18	71	44.20	74
2009	0.14	72	28.08	74

Sources: Amy Joyce. (2007). Circuit City's Job Cuts Backfiring, Analysts Say. Washington Post, May 2, p. D1. Stock price data from www.moneycentral.com. ASCI = American Customer Satisfaction Index, http://www.theacsi.org/. David Bogoslaw. (2007). Circuit City gets crushed. *BusinessWeek,* December 2.

Notes: Stock symbol for Circuit City is CCTYQ and for Best Buy is BBY. ASCI scores for Circuit City and Best Buy available from 2004 forward.

Summary

The model presented in this chapter provides a structure for understanding compensation systems. The three main components of the model are the compensation objectives, the policy decisions that guide how the objectives are going to be achieved, and the techniques that make up the pay system and link the policies to the objectives. The following sections of the book examine each of the four policy decisions—internal alignment, external competitiveness, employee performance, and management—as well as the 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 goals? If good answers to the "so-what" question are not apparent, there is no point to the technique. Adapting the pay system to meet the needs of the employees and helping to 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 have been designed in response to some historical but long-forgotten problem. The practices continue, but the logic underlying them is not always clear or even relevant. The next generation pay systems hopefully will be more flexible—designed to achieve specific objectives under changing conditions.

Review Questions

1. How do differing perspectives affect our views of compensation?
2. 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 with more experience, someone from another country, someone from another field of study.
3. What is the "network of returns" that your college offers your instructor? What returns do you believe make a difference in teaching effectiveness? What "returns" would you change or add to increase the teaching effectiveness?
4. What are the four policy issues in the pay model? What purposes do the objectives in the pay model serve?
5. List all the forms of pay you receive from work. Compare your list to someone else's list. Explain any differences.
6. Answer the three questions in the *Caveat Emptor—Be An Informed Consumer* section for any study or business article that tells you how to pay people.

Endnotes

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3. Bill Vlasic and Nick Bunkley. "GM's Latest Plan Envisions a Much Smaller Automaker." *New York Times,* April 28, 2008.

4. W. G. Sanders and D. C. Hambrick, "Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance," *Academy of Management Journal* 50 (2007), pp. 1055–1078; Cynthia E Devers, Gerry McNamara, Robert M. Wiseman, and Mathias Arrfelt, "Moving Closer to the Action: Examining Compensation Design Effects on Firm Risk," *Organization Science* 19, July–August 2008, pp. 548–566.

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