Strategic Compensation

A Human Resource Management Approach





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A Human Resource Management Approach

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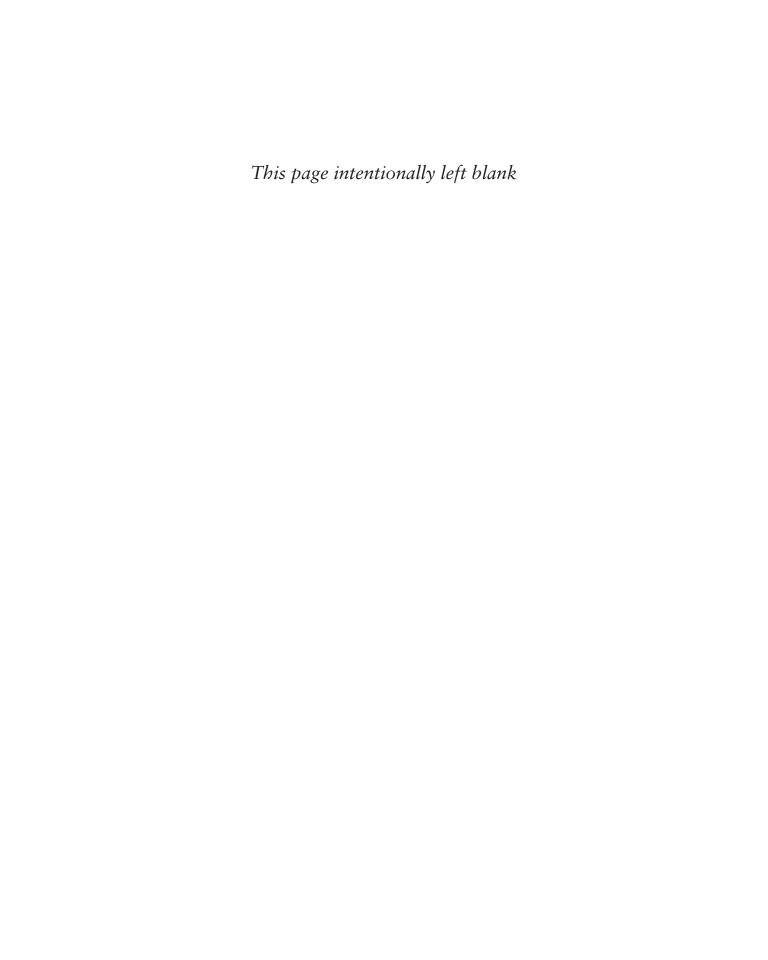
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Chapter 14



Preface

NEW TO THIS EDITION

Strategic Compensation: A Human Resource Management Approach, Tenth Edition, contains substantial new content and changes, including the following:

- Three new features appear in each chapter that enable students to integrate knowledge and valuable skills regardless of whether they are choosing a career in the compensation profession or other business functions in smaller or larger organizations.
 - Ethics Dilemma. Ethics is the discipline dealing with what is good and bad, right and wrong, or with moral duty and obligation. Most executives, managers, and professionals believe that integrity and ethical values have an important place in business and should form the foundation of a company's culture. Ethics focuses on individual decision making and behavior as well as the impact of ethical choices on employee welfare. The Ethics Dilemma, presented in the end-of-chapter material, will keep these important matters in the forefront as you move ahead in your career.

Case 2: Ethics Dilemma: Pay for Performance Disconnect

You are the new vice president for HR of a company that has not been performing well, and everyone, including yourself, has a mandate to deliver results. The pressure has never been greater. Shareholders are nargy after three years of a tough market that has left their company stock losing value every day. Many shareholders desperately need stock performance to pay for their retirement. Working for you is a 52-year-old manager with two kids in college. In previous evaluations, executives told him he was doing fine, when he clearly was not, and his performance is still far below par. At the same time, the executives awarded him impressive annual pay raises.

If you are to show others in the company that you are willing to make tough decisions, you feel you must fire this individual. The question is, who is going to suffer—the firm and, ultimately, the shareholders, whose retirements are in jeopardy—or a nice guy who's been lied to for 20 years?

Ouestions:

3-9. What would you do?

3-10. What factor(s) in this ethical dilemma might influence a person to make a less-than-ethical decision?

FYI

Both private-sector companies and the federal government are competing for cyber security talent; however, the difference in annual pay between the government and private sector is staggering, particularly for chief information officer jobs:

- Private-sector: \$500,000 to \$2,000,000
- Federal government: \$123.175 to \$185.100¹⁴

■ **FYI.** This feature provides tidbits of information from survey research and extensive databases (e.g., employment statistics) that illustrates trends, opinions, and the use of specific compensation practices.

■ Working Together. This feature offers opportunities for students to collaborate through sharing ideas, listening to others' ideas, and coming up with a cohesive team response to the assignment.

Working Together: Team Exercise

In small groups of three or four, come up with specific answers to the following questions. Talk through your perspectives and come up with a team response. Be prepared to share your ideas with the class.

We studied competency models in this chapter and viewed the U.S. Department of Labor competency model framework (Figure 5-1). The Department of Labor has the Competency Model Clearinghouse that contains several competency models across industries. As a group, review some of these competency models available on the Careeronestop website (https://www.careeronestop.org/CompetencyModel/) after clicking on the industry models link. Select a competency model from two industries.

Questions:

- **5-14.** Summarize the information available on your chosen models. What are some of the similarities?
- 5-15. What are some of the differences in occupation- and industry-competencies between your chosen models?
- Other major updates to the tenth edition include:
 - Extend coverage of evolving compensation practices, statistics, and business professionals' perspectives. For instance, Chapter 3 (Traditional Bases for Pay: Seniority and Merit) includes a section on trends in performance appraisal practice. In a nutshell, some companies are providing performance feedback more frequently and as needed on a less structured basis rather than putting off providing feedback until structured annual reviews are given. This section also addresses the pros and cons of this more contemporary thinking as well the same for longstanding approaches to provide students a balanced view.
 - Chapter 15 has been converted into an Epilogue. It includes many important topics not covered in previous editions and makes significant updates to other topics. Some of the topics are the compensation productivity gap, the gender pay gap, and pay transparency.
 - Fifty percent of the Cases and nearly fifty percent of the Crunch the Numbers features are new.

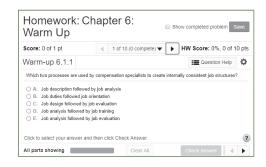
SOLVING TEACHING AND LEARNING CHALLENGES

Increasingly, students expect to see the applicability of their coursework to life and work after graduation. When the connection is not clear to students, many may lose interest and, perhaps, choose to do as little as possible to earn a good enough grade on quizzes and exams. The choice of pedagogical features and the writing style in this text would pique interest in the subject matter and enhance learning and development of seven critical employability skills, which have been discussed in the 'Developing skills for your career' section in this textbook.

Strategic Compensation: A Human Resource Management Approach provides the foundation for building compensation systems in a variety of work organizations. The content of this textbook establishes the structure and design elements of compensation systems in a forward-looking framework that addresses decision making that supports companies' strategic plans. This approach, therefore, positions compensation practice as essential and compensation professionals as business partners. Individuals who pursue careers outside the compensation field will understand how to interact with compensation professionals for promoting effective recruitment, motivation, and retention of talent. This textbook is readable with a conversational tone and clear explanations for concepts and practices. It conveys the relevance of compensation system design overall as well as individual topics for organizations and aspiring professionals; and, this textbook takes on contemporary topic coverage in every chapter.

I approach the study of compensation in a realistic, practical, interesting, and stimulating manner. I focus on showing how compensation is practiced in the real world. Throughout the book, you will see examples of how organizations practice compensation management. In explaining a concept, I often quote compensation professionals and other business professionals, yet all compensation discussion is based on sound theoretical concepts and practice. Where appropriate, the strategic role of compensation is apparent, particularly in Chapter 1. In addition, I show how compensation practices are related to other Human Resource Management (HRM) topics. For instance, a firm that emphasizes recruiting top-quality candidates but neglects to provide satisfactory compensation is wasting time, effort, and money. If a firm's compensation system pays below-market wages, the firm will always be hiring and training new employees only to see the best leave for a competitor's higher wages. Besides this one example, the interrelationship of compensation practices set in a dynamic business environment will become more obvious as these topics are addressed throughout the book. These interrelationships are also shown to be important as organizations operate within the global environment. I included several features that appear in the textbook and MyLab (some of which are listed and discussed below) to actively engage students in the learning experience.

To improve student results, I recommend pairing the text content with MyLab Management, which is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and will help your students learn and retain key course concepts while developing skills that future employers are seeking in their candidates. From Videos to Personal Inventory Assessments, MyLab Management helps you teach your course, your way. Learn more at www.pearson.com/mylab/management.

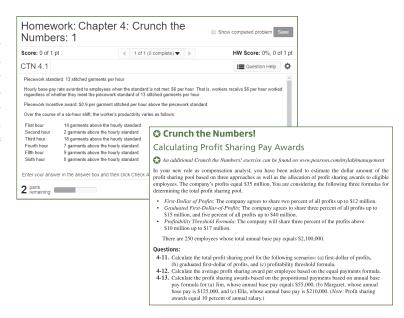


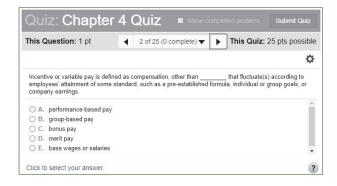
Chapter Warm-Ups

Chapter Warm-Up assessment helps you hold your students accountable for learning key concepts in each chapter. These questions can be assigned to the students ahead of time and will ensure that they are coming to class prepared.

Crunch the Numbers Exercises

Crunch the Numbers provide an excellent opportunity to sharpen problem solving skills through the analysis of numerical data, creating the foundation for quantifying compensation concepts and practices. There are two data-driven exercises per chapter, one in the book and both in MyLab Management. Answers are found in the Instructors Manual and in MyLab Management.





Chapter Quizzes

A powerful tool used to assess your students understanding of the chapter learning objective after studying the chapter. After reading the chapter, these questions can be assigned to the students to test the knowledge they gained for respective topic(s).

Videos Exercises

Video exercises are available for select chapter topics to help engage students and hold them accountable for their learning. A video clip can be assigned to students for outside classroom viewing or it can be watched in the classroom. The video corre-

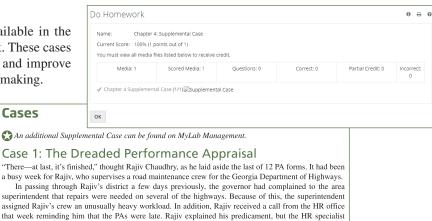
sponds to the chapter material and is accompanied by multiple choice questions that reinforce student's comprehension of the chapter content.

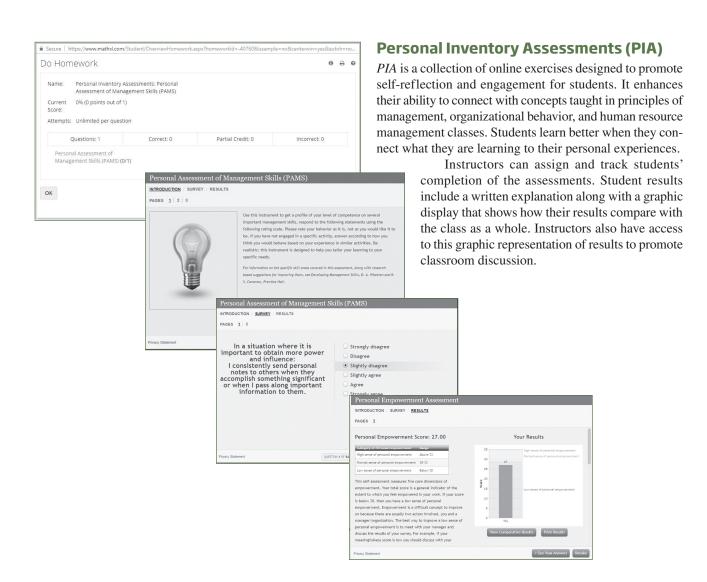


XVIII Preface

Cases

Additional Supplemental cases are available in the MyLab to complement cases in the book. These cases help to keep students actively engaged and improve skills like problem solving and decision making.





insisted that the forms be completed right away.

Compensation in Action

Compensation in Action explains how compensation professionals and managers throughout an organization work together to address important workplace issues. This feature highlights some of the specific connections between managers and compensation professionals, and the reality that compensation activities are never performed in isolation.

PREPARING FOR MY CAREER

Compensation in Action

Employee compensation will ultimately be a managerial decision. As a line manager, your focus will be on the broader issues of production, revenue, and competition; however, the rate at which employees are paid—and why—will be an important factor in sustaining high levels of production, revenue, and competitive advantage. In making these decisions, line managers and HR (and in many cases the compensation specialist within the HR department) must work together in order to reward employees on measurable accomplishments and effectively communicate how the measured performance led to the resulting compensation decision.

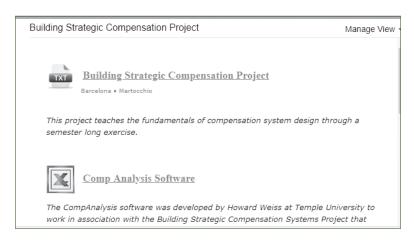
Working Together Exercises

As noted earlier, *Working Together* offers opportunities for students to collaborate through sharing ideas, listening to others' ideas, and coming up with a cohesive team response to the assignment. If assigned by the instructor, students may make brief oral presentations of their ideas to the class, creating an additional opportunity for working together.

Building Strategic Compensation Systems Project

Building Strategic Compensation Systems Project is an experiential case, available online in MyLab Management. It allow students to work in small compensation consulting teams charged with the

responsibility for developing a compensation plan for a company named *e-sonic*. The project is divided into four sections. The first section, Strategic Analysis, is described fully in the casebook for faculty and students who choose to complete this optional analysis of the business environment prior to the remaining three sections that directly address compensation system design, as it relates to Chapter 1 of the textbook. Section two relates to Chapter 6 of the book and introduces students to the specification of internally consistent job structures. Section three relates to Chapter 7 of this book and shifts students' focus outside of their firm to understand its relationship with the external marketplace. Finally, in Section four, students



will recognize the contributions of employees through the creation of a merit-pay system and put their plan into action by paying employees within their firm. This section relates to Chapters 2 through 5, 8 through 9 in the book.

DEVELOPING EMPLOYABILITY SKILLS

For students to succeed in a rapidly changing job market, they should be aware of their career options and how to go about developing a variety of skills. In this book and MyLab, students will have the opportunity to develop and practice seven important skills based on various learning features that are summarized in the matrix (given on the following page) and subsequently illustrating some of the connections between the employability skills and learning features:

	Communication	Critical Thinking	Collaboration	Knowledge Application and Analysis	Business Ethics and Social Responsibility	Information Technology and Computing Skills	Data Literacy
FYI				1			1
Watch It!		1		1			
Personal Inventory Assessment			1	1			
Compensation in Action	1		1	1			
Case (end-of-chapter)		1		1	1		
Ethics Dilemma		1		1	1		
Crunch the Numbers!		1		1		1	✓
Working Together: Team Exercise	1		1	1			
Building Strategic Compensation Systems (accompanying case)	1	1	1	1		1	1

INSTRUCTOR TEACHING RESOURCES

Strategic Compensation comes with the following teaching resources.

Supplements available to instructors at www.pearsonhighered.com/irc	Features of the Supplement
Instructor's Manual authored by Lori Long	 Chapter-by-chapter summaries Examples and activities not in the main book Teaching outlines Solutions to all questions and problems in the book
Test Bank authored by Angela Boston	More than 650 multiple-choice, true/false, short-answer, and graphing questions with these annotations: • Difficulty level (1 for easy, 2 for moderate, 3 for difficult) • Type (Multiple-choice, true/false, short-answer, essay) • Topic (The term or concept the question supports) • Learning objective • AACSB learning standard (Written and Oral Communication, Ethical Understanding and Reasoning; Analytical Thinking; Information Technology; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge; Interpersonal Relations and Teamwork)
Computerized TestGen©	TestGen allows instructors to: Customize, save, and generate classroom tests Edit, add, or delete questions from the Test Item Files Analyze test results Organize a database of tests and student results.
PowerPoints authored by Patricia Buhler	Slides include many of the figures and tables in the textbook PowerPoints meet accessibility standards for students with disabilities. Features include, but are not limited to: • Keyboard and Screen Reader access • Alternative text for images • High color contrast between background and foreground colors

ACKNOWLEDGMENTS

I thank the multitude of course instructors and students who have used past editions of my book. Their invaluable insights and constructive feedback has helped me to improve both the instructor's teaching and students' learning experiences.

At Pearson, I wish to thank my editor, Neeraj Bhalla for championing this edition and providing support throughout the revision process. Many others at Pearson provided expert advice and project management oversight, including my content producers, Shweta Jain and Sugandh Juneja. At SPi Global, I thank Bhanuprakash Sherla and his colleagues for their expert oversight of the process and keen eye for details.

ABOUT THE AUTHOR



Joseph J. Martocchio

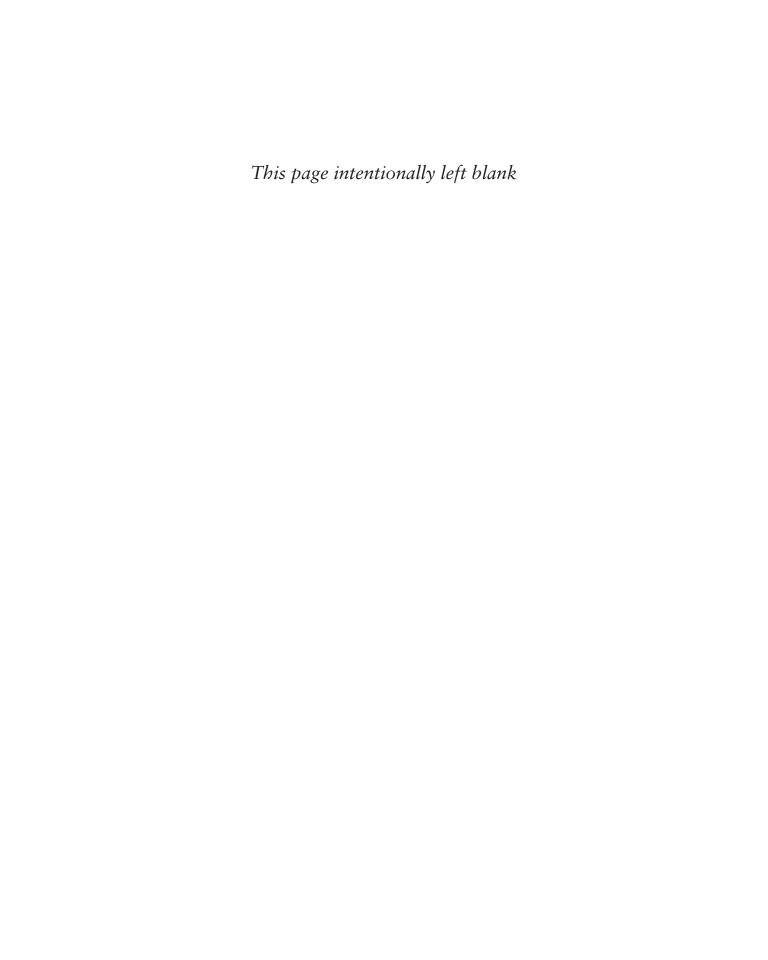
My interest in the human resource management field began while I was a junior at Babson College and in compensation, particularly, while I was a first-year graduate student at Michigan State University. I found myself wanting to practice in the field as well as to become a university professor and researcher. I pursued both professional desires starting with employment at Cameron and Colby (a reinsurance company) in Boston and General Electric's Aerospace business group in Valley Forge, Pennsylvania.

I advanced my education in the human resource management (HRM) field by earning a master's degree and Ph.D. degree at Michigan State University. My master's degree enabled me to build an even stronger foundation in practice and my doctoral degree provided me with the skills to conduct scholarly research and teach college-level courses. Since earning my graduate degrees, I have been a professor in the School of Labor and Employment Rela-

tions at the University of Illinois, Urbana–Champaign and assumed administrative roles as a Provost Fellow, Associate Dean for Academic Affairs, and Interim Dean. All the while, I have taught a variety of courses in the HRM field. These include compensation systems, employee benefits, employment systems (HRM and labor relations), HR planning and staffing, and statistics. I also teach the compensation and statistics courses online. For many years, I served as the faculty advisor to the student chapter of the Society for Human Resource Management at the University of Illinois during which time students earned Merit Awards and Superior Merit awards on multiple occasions.

As a researcher, I have studied a variety of topics that include employee absenteeism, employee training and development, compensation systems, employee benefits, and generational diversity. My work appears in leading scholarly journals such as *Academy of Management Journal*, *Academy of Management Review*, *Journal of Applied Psychology*, *Journal of Management*, and *Personnel Psychology*. I received the Ernest J. McCormick Award for Distinguished Early Career Contributions from the Society for Industrial and Organizational Psychology (SIOP), and I was subsequently elected as a Fellow in both the American Psychological Association and SIOP. Following the attainment of this recognition, I served as the Chair of the HR Division of the Academy of Management as well as in various other leadership roles within that organization.

In 2018, a study in the *Academy of Management Learning and Education* revealed that I am in the top one percent of the most influential HRM authors out of a total of 9,744. Besides writing scholarly articles and *Strategic Compensation: A Human Resource Management Approach*, I have two additional sole-authored textbooks: *Human Resource Management* (Pearson Higher Education), 15th edition, and *Employee Benefits: A Primer for Human Resource Professionals* (McGraw-Hill), 6th edition.



SETTING THE STAGE FOR STRATEGIC COMPENSATION



CHAPTER 1 STRATEGIC COMPENSATION

CHAPTER 2 CONTEXTUAL INFLUENCES ON COMPENSATION PRACTICE

MyLab Management

You can access the CompAnalysis Software to complete the online Building Strategic Compensation Systems Project by logging into www.pearson.com/mylab/management.



Strategic Compensation A Component of Human Resource Systems

Learning Objectives

When you finish studying this chapter, you should be able to:

- **1-1.** Define strategic compensation.
- **1-2.** Summarize the role of compensation as a strategic business partner.
- **1-3.** Explain strategic compensation decisions.
- **1-4.** Identify and discuss the building blocks and structural elements of strategic compensation systems.
- **1-5.** Describe the fit of the compensation function in organizations.
- **1-6.** Identify the stakeholders of the compensation function and summarize their stakes in the work compensation professionals perform.
- **1-7.** Explore essential skills for developing your career in compensation or any other career path.

CHAPTER WARM-UP!

If your professor has assigned this, go to the Assignments section of www.pearson.com/mylab/management to complete the Chapter Warm-Up! and see what you already know. After reading the chapter, you'll have a chance to take the Chapter Quiz! and see what you've learned.

Through the early twentieth century, manpower planning was the predecessor to contemporary human resource (HR) management. Manpower planning focused on the effective deployment of employees in factories to achieve the highest manufacturing output per employee per unit of time. That is, management sought to increase productivity (such as the number of handmade garments per hour) while also maintaining or lowering employee compensation costs. All else equal, higher employee productivity while maintaining or lowering employee compensation costs contributed to higher profitability for the firm.

Through the decades, mounting government regulation involving payroll taxes and laws centered on ensuring a minimum wage, prevailing wage, equal pay for equal work; and, equal employment opportunity later gave rise to the personnel management function, of which compensation was a component. Legal compliance necessitated that personnel management take on the role of an administrative, support function to maintain compliance with the myriad details of employment laws (e.g., determining prevailing wages in localities). Personnel management

departments also engaged in transactions (e.g., payroll administration) with an eye toward administrative efficiency. Administrative efficiency is essential because it can indirectly contribute to company success through cost control.

Since the early 1980s, there has been growing widespread recognition that managing employees or human resources can contribute more directly to competitive advantage. Competitive advantage describes a company's success when the company acquires or develops capabilities that facilitate outperforming the competition. For example, Walmart is a successful retailer, in part, because its sheer size enables it to negotiate lower prices with suppliers (e.g., of clothing) than smaller retailers. In turn, Walmart can sell products at a price advantage relative to most competitors. Other resources may include the employment of highly skilled employees who can operate and troubleshoot problems with sophisticated robotic equipment, which can increase the pace of production while also maintaining quality.

Designing HR practices with competitive advantage in mind casts HR as a strategic function rather than as one that focuses exclusively on conducting transactions. In a strategic role, HR professionals proactively put forth forward-looking principles and ideas, and they play an important role in contributing to successful business outcomes by attracting, motivating, and retaining highly qualified employees.

DEFINING STRATEGIC COMPENSATION

"What is strategic compensation?" Answering this question requires that we first answer the 1-1. Define strategic question, "What is compensation?"

compensation.

What Is Compensation?

Compensation represents both the intrinsic and extrinsic rewards employees receive for performing their jobs and for their membership as employees. Together, both intrinsic and extrinsic compensation describe a company's total compensation system, which we will look at more closely in this chapter, and, in even greater detail throughout the remainder of this textbook.

Intrinsic compensation reflects employees' psychological mind-sets that result from performing their jobs, for example, experiencing a great feeling from the belief that one's work matters in the lives of others. Perhaps it is easy to imagine that many health care providers feel this way. Extrinsic compensation includes both monetary and nonmonetary rewards. Organizational development professionals promote intrinsic compensation through effective job design. Compensation professionals are responsible for extrinsic compensation, which is the focus of this textbook.

Compensation professionals work with high-level managers to determine the best compensation plans that will contribute to recruitment, employee job performance, and retention. Then, compensation professionals use their expertise to establish monetary compensation programs to reward employees according to their job seniority, performance levels, or for learning jobrelated knowledge or skills. Some describe this exchange as a pay-effort bargain. As we will discuss shortly, monetary compensation represents core compensation. Nonmonetary rewards include protection programs (e.g., health insurance), paid time off (e.g., vacations), and services (e.g., day care assistance). Most compensation professionals refer to nonmonetary rewards as employee benefits. Employees receive some or all of these offerings as part of an employment arrangement. Rarely do employers base employee benefits on job performance. Employee benefits are becoming an increasingly important element of compensation packages. Since the so-called Great Recession (2007–2009) ended, many companies now offer lower pay increases (from an average 3.8 percent annual increase to less than 3 percent)¹ to better control costs and build cash reserves for a "rainy day." Another reason for lower pay increases is the rising cost of health care coverage, which employers are required to provide full-time employees under the Patient Protection and Affordable Care Act of 2010, or else pay a substantial monetary penalty.

Both monetary and nonmonetary compensation represents costs to companies. In the case of core compensation, employers pay an hourly wage or salary. In the case of employee benefits, employers pay some or the entire cost for employees to have health insurance coverage rather than providing dedicated monetary payments, apart from wage or salary, to pay for health care coverage and contributions to a retirement savings plan, among others.

What Is Strategic Compensation?

Defining strategic compensation requires that we place the relevance and importance of compensation practices in a broader context where compensation practices are linked to competitive business strategy, as shown in Figure 1-1. Competitive business strategy refers to the planned use of company resources—financial capital, equipment capital, and human capital—to promote and sustain competitive advantage. The time horizon for strategic decisions may span multiple years. For example, Netflix company leadership maintains that "Now internet entertainment—which is on-demand, personalized, and available on any screen—is replacing linear TV." Netflix's success is largely due to its ability to capitalize on changing technology and consumer preferences as well as produce popular content. The company has been highly successful. In the last three months of 2017 alone, Netflix added 8.3 million subscribers globally.

Human resource executives collaborate with company executives to develop human resource strategies. Human resource strategies specify the use of multiple HR practices to reinforce competitive business strategy. These statements are consistent with a company's competitive strategy. For example, Samsung emphasizes the essential role of its employees as it endeavors "to create a better world full of richer digital experiences, through innovative technology and products: For this, we dedicate our efforts to creativity and innovation, shared value with our partners, and our great people [employees]."⁴

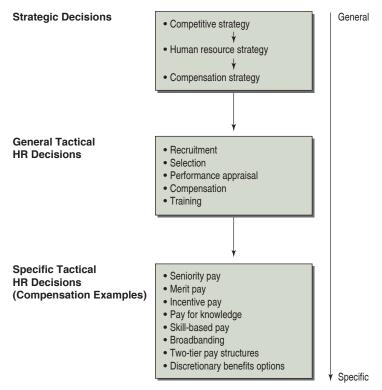


FIGURE 1-1 Relationship between Strategic Decisions and Compensation Practices

Within the context of competitive business strategy and human resource strategy, compensation professionals practice strategic compensation. **Strategic compensation** refers to the design and implementation of compensation systems to reinforce the objectives of both HR strategies and competitive business strategies. Compensation and benefits executives work with the lead HR executive and the company's chief financial officer (CFO) to prepare total compensation strategies. For example, pharmaceutical manufacturer Eli Lilly is well known for offering a balanced compensation and benefits program which recognizes employee contributions and embraces employees through recognition of their needs outside the workplace.⁵

COMPENSATION AS A STRATEGIC BUSINESS PARTNER

As noted earlier, personnel administration in the 1980s was transformed from a purely administrative function, engaged in transactions such as payroll processing, to a competitive resource in many emerging companies. Technological advances (e.g., the use of robotics in manufacturing), global competition (e.g., increased imports of Japanese and South Korean automobiles), and shifts in the composition of the workforce (e.g., a gap in leadership as many baby boom era employees retire) have contributed greatly to the need for a strategic approach.⁶ As a strategic business partner, HR and compensation professionals today need to think like the chief executive officer (CEO) to become a strategic partner in achieving organizational plans and results.⁷ Essentially, they must know more than just HR work.⁸ For example, GE's Human Resources Leadership Program (HRLP)⁹ is an exemplar of these ideas. The HRLP provides participants with opportunities to learn HR competencies, global leadership skills, and business acumen through formal training and rotational assignments in areas such as compensation, staffing, and employment relations. Participants also receive exposure to GE executives and HR leaders to put their work in the context of strategic issues facing the company. In doing so, they understand the production and service sides of the business and help to determine the strategic capabilities of the company's workforce, both today and in the future. For example, increasing sales and building brand loyalty are important goals of soft drink companies such as Coca-Cola and PepsiCo. Increasing sales requires hiring highly dedicated and motivated sales employees whose success is rewarded through innovative sales incentive arrangements.

Compensation professionals can give the CEO and CFO a powerful understanding of the role that employees play in the organization and the way it combines with business processes to expand or shrink shareholder value. Compensation professionals are integrating the goals of compensation with the goals of the organization and focusing on expanding its strategic and high-level corporate participation with an emphasis on adding value.

Perhaps a useful way to better understand *how* HR functions serve as a strategic business partner is to think about the role of capital for value creation. Capital refers to the factors that enable companies to generate income, higher company stock prices, economic value, strong positive brand identity, and reputation. There is a variety of capital that companies use to create value, including financial capital (cash) and capital equipment (state-of-the-art robotics used in manufacturing). Employees represent a specific type of capital called human capital. Human capital, as defined by economists, refers to sets of collective skills, knowledge, and abilities that employees can apply to create value for their employers. Companies purchase the use of human capital by paying employees an hourly wage or salary and providing benefits such as paid vacation and health insurance.

Compensation professionals can help leverage the value of human capital in a variety of ways. For example, well-designed merit pay programs reinforce excellent performance by awarding pay raises commensurate with performance attainments. The use of incentive pay practices is instrumental in changing the prevalent entitlement mentality U.S. workers have toward pay and in containing compensation costs by awarding one-time increases to base pay once work objectives have been attained. Pay-for-knowledge and skill-based pay programs are

1-2. Summarize the role of compensation as a strategic business partner.

key to giving employees the necessary knowledge and skills to use new workplace technology effectively. Management can use discretionary benefit offerings to promote employee behaviors that have strategic value. For example, employees who take advantage of tuition reimbursement programs gain knowledge and skills that directly add value to the work they do. In line with these ideas, Bosch offers a unique program to individuals who are pursuing PhD degrees at well-respected universities. ¹⁰ The company hires doctoral candidates on a limited-term basis while these students undertake dissertation work under the auspices of Bosch scientists who are working on pressing company matters of scientific importance. This arrangement is a win–win situation because students have direct access to research facilities and Bosch benefits from individuals who are gaining state-of-the-art knowledge and skills in their doctoral programs.

STRATEGIC COMPENSATION DECISIONS

1-3. Explain strategic compensation decisions.

Compensation professionals provide a strategic contribution to the company when they can answer *yes* to the following three questions:

- Does compensation strategy fit well with the objectives of competitive business and HR strategies?
- Does the choice and design of compensation practices fit well to support compensation strategy?
- Does the implementation of compensation practices effectively direct employee behavior to enhance job performance that supports the choice of compensation practices?

Companies base strategy formulation on environmental scanning activities. Discerning threats and opportunities is the focus of environmental scanning. A threat suggests a negative situation in which loss is likely and over which an individual has relatively little control. An opportunity implies a positive situation in which gain is likely and over which an individual has a fair amount of control. ¹¹

For instance, small specialty coffee shops are facing several *threats*, four of which are noted here. First, prices tend to be higher in small shops than in large-chain shops such as Dunkin' Donuts and Starbucks whose large sizes enable them to purchase coffee beans at a lower cost. Second, competition from unlikely sources has emerged in recent years. Gas stations have jumped into this market space by offering premium coffees at substantially lower prices than specialty coffee shops. Third, the rise in work-from-home arrangements has contributed to a decline in coffee shop patronage. Fourth, further pressures include a rising minimum wage rate throughout many cities and states, and soaring rental rates for retail space in prime locations. ¹²

Government regulation provides U.S. pharmaceutical companies with the opportunity to recoup research and development costs as well as generate profits from the sale of products for which they have U.S. patent protection. For a limited period of a few to several years, the U.S. government grants these companies exclusivity. That is, no other company may manufacture or sell the product during this period. Without exclusivity provisions, pharmaceutical companies such as Wyeth Pharmaceuticals would be placed at a competitive disadvantage because other companies would manufacture and distribute a therapeutically equivalent product at a lower cost. For example, Wyeth Pharmaceuticals developed Protonix, a product which treats gastro esophageal reflux disease. The company enjoyed exclusivity protection for several years. The expiration of an exclusivity clause poses a threat for, in this case, Wyeth Pharmaceuticals; yet, an opportunity for more pharmaceutical companies to compete for market share. For example, Teva Pharmaceuticals has been selling pantoprazole, a therapeutically generic version of Protonix, at a lower price. These so-called generic alternatives are less expensive because companies that manufacture and distribute them do not have research and development costs to recoup. Adding to the threat to brand names, most health insurance companies refuse to provide coverage for brand name products where less expensive generic alternatives are available.

Competitive Business Strategy Choices

Companies use a variety of terms to describe competitive business strategy choices. These choices fundamentally focus on attaining competitive advantage either by achieving lowest cost or product (service) differentiation. Most companies pursue strategies that contain elements of both.

LOWEST-COST STRATEGY The **cost leadership** or **lowest-cost strategy** focuses on gaining competitive advantage by being the lowest-cost producer of a product or service within the marketplace, while selling the product or service at a price advantage relative to the industry average. Lowest-cost strategies require aggressive construction of efficient-scale facilities and vigorous pursuit of cost minimization in areas such as operations, marketing, and HR.

IKEA, a low-cost furniture manufacturer, is an excellent illustration of an organization that pursues a lowest-cost strategy because its management successfully reduced operations costs. Three noteworthy decisions have contributed to IKEA's goals. First, IKEA sources its products to countries where labor costs are low. Second, the company provides a low level of service to consumers. For example, IKEA does not assemble furniture. It also does not deliver furniture to people's homes. Instead, IKEA sends orders to warehouses where the customer is responsible for picking up purchases. Customers are willing to make significant efforts to retrieve and assemble furniture because prices are much lower than full-service manufacturers and retailers. The third point also illustrates threats to maintaining strategic objectives. Rising raw material costs has prompted IKEA to consider the use of alternative lower cost material, including bamboo, without compromising the quality of their products.

DIFFERENTIATION STRATEGY Companies adopt **differentiation strategies** to develop products or services that are unique from those of their competitors. Differentiation strategy can take many forms, including design or brand image, technology, features, customer service, and price. Differentiation strategies lead to competitive advantage through building brand loyalty among devoted consumers. Brand-loyal consumers are probably less sensitive to price increases, which enables companies to invest in research and development initiatives to further differentiate themselves from competing companies.

Apple Computer relies on a differentiation strategy to increase market demand and loyalty. Apple's products are successful, in large part, because they have always been designed to be on the leading edge compared to the competition. Even in the face of strong competition, Apple continually excels in creating demand for its products such as iPhones, iPads, and iPods, enabling them control over pricing through product differentiation, innovative advertising, and creative publicity prior to unveiling products.

The following Watch It! video illustrates the basics of competitive business strategy. These concepts, which we've described previously, are illustrated by comparing the strategies of two computer manufacturers, ACER and Hewlett-Packard.

WATCH IT!

If your professor has assigned this, go to the Assignments section of www.pearson.com /mylab/management to complete the video exercise.

Compensation Decisions that Support the Firm's Strategy

Compensation professionals support strategic initiatives through the design and implementation of compensation systems. Two broad elements are the basis for compensation professionals' work. These include basic building blocks and structural design elements, which we will introduce later in this chapter. For example, compensation professionals make decisions about whether to use (and how to design) pay-for-performance practices, whether to set pay levels that exceed typical market pay rates, and whether to create a pay mix that

emphasizes long-term over short-term incentives. The totality of choices should fit well with cost or differentiation objectives and with an eye toward rewarding behaviors that support these objectives.

Employee Roles Associated with Competitive Strategies

Common wisdom and experience tell us that HR professionals must decide which employee roles are instrumental to the attainment of competitive strategies. Knowledge of these required roles should enable HR professionals to implement HR practices that encourage enactment of these roles. Of course, compensation professionals are responsible for designing and implementing compensation practices that elicit strategy-consistent employee roles.

For the lowest-cost strategy, the imperative is to reduce output costs per employee. The desired employee roles include repetitive and predictable behaviors, a relatively short-term focus, primarily autonomous or individual activity, high concern for quantity of output, and a primary concern for results. Successful differentiation strategies depend on employee creativity, openness to novel work approaches, and willingness to take risks. Design thinking has recently received much attention and is appropriate in companies that pursue a differentiation strategy. It has been described as "approaching management problems as designers approach design problems." PepsiCo embraces the importance of design thinking. For example, the company designers created the Pepsi Spire, which is a high-tech beverage dispensing machine with a futuristic design. PepsiCo CEO Indra Nooyi had this to say about the company's design approach: "Other companies with dispensing machines have focused on adding a few more buttons and combinations of flavors. Our design guys essentially said that we're talking about a fundamentally different interaction between consumer and machine." In addition, differentiation strategies require longer time frames to provide sufficient opportunity to yield the benefits of these behaviors.

BUILDING BLOCKS AND STRUCTURE OF STRATEGIC COMPENSATION SYSTEMS

1-4. Identify and discuss the building blocks and structural elements of strategic compensation systems.

As we discussed previously, extrinsic compensation includes both monetary (core compensation) and nonmonetary rewards (employee benefits). Figure 1-2 lists the main compensation building blocks. The building blocks are embedded within a system of three structural elements that ultimately support compensation strategies. These structural elements include internally consistent job structures, market competitive pay structures, and structures that recognize employee contributions.

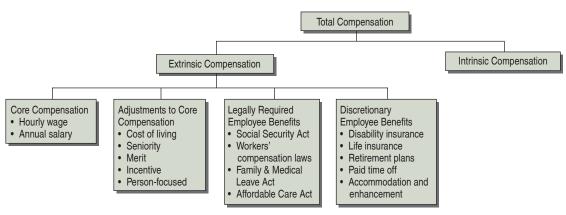


FIGURE 1-2 Compensation System Building Blocks

TABLE 1-1 Elements of Core Compensation

Base Pay

- · Hourly pay
- · Annual salary

How Base Pay Is Adjusted over Time

- · Cost-of-living adjustments
- · Seniority pay
- Merit pay
- · Incentive pay
- Person-focused pay or competency-based pay: pay-for-knowledge, skill-based pay

Building Blocks: Core Compensation and Employee Benefits

CORE COMPENSATION There are two categories of core compensation: base pay and base pay adjustments over time. The specific practices associated with each category are listed in Table 1-1.

Employees receive **base pay**, or money, for performing their jobs (Chapter 7). Base pay is recurring; that is, employees continue to receive base pay as long as they remain in their jobs. Companies disburse base pay to employees in one of two forms: **hourly pay or wage**, or as **annual salary**. Employees earn hourly pay for each hour worked. Salaried employees earn salaries for performing their jobs, regardless of the actual number of hours worked throughout the year. Companies measure salary on an annual basis. The Fair Labor Standards Act (FLSA) (Chapter 2) established criteria for determining whether employees should be paid hourly or by salary. In 2017, the average hourly rate for workers was \$24.33. On an annual basis, this figure translates to \$50,620.

Companies typically set base pay amounts for jobs according to the level of skill, effort, and responsibility required to perform the jobs and the severity of the working conditions. Compensation professionals refer to skill, effort, responsibility, and working condition factors as **compensable factors** because they influence pay level (Chapters 2 and 6). Courts of law use these four compensable factors to determine whether jobs are equal per the Equal Pay Act of 1963 (EPA). According to the EPA, it is against the law to pay women less than men for performing equal work though there are exceptions, which we will discuss in Chapter 2. Compensation professionals use these compensable factors to help meet three pressing challenges, which we will introduce later in this chapter: internal consistency (Chapter 6), market competitiveness (Chapter 7), and recognition of employee contributions (Chapter 8).

Over time, employers adjust employees' base pay to recognize increases in the cost of living, differences in employees' performance, or differences in employees' acquisition of job-related knowledge and skills. We will discuss these core compensation elements next.

Cost-of-living adjustments (COLAs) represent periodic base pay increases that are founded on changes in prices as recorded by the Consumer Price Index (CPI). In recent years, the typical COLA equaled approximately 2 to 3 percent annually. COLAs enable workers to maintain their purchasing power and standard of living by adjusting base pay for inflation. COLAs are most common among workers represented by unions. Union leaders fought hard for these improvements to maintain their members' loyalty and support. Many employers use the CPI to adjust base pay levels for newly hired employees.

Seniority pay systems reward employees with periodic additions to base pay according to employees' length of service in performing their jobs (Chapter 3). These pay plans assume that employees become more valuable to companies with time and that valued employees will leave if they do not have a clear idea that their wages will progress over time. This rationale comes from human capital theory, ¹⁶ which states that employees' knowledge and skills

(human capital) add value. Employees can develop such knowledge and skills from formal education and training, including on-the-job experience. Over time, employees presumably refine existing skills or acquire new ones that enable them to work more productively. Seniority pay rewards employees for acquiring and refining their skills as indexed by length (years) of employment.

Merit pay programs assume that employees' compensation over time should be determined, at least in part, by differences in job performance as judged by supervisors or managers (Chapter 3). Employees earn permanent increases to base pay according to their performance. Merit pay rewards excellent effort or results, motivates future performance, and helps employers retain valued employees.

Incentive pay or variable pay rewards employees for partially or completely attaining a predetermined work objective. Incentive pay is defined as compensation (other than base wages or salaries) that fluctuates according to employees' attainment of some standard based on a preestablished formula, individual or group goals, or company earnings (Chapter 4).

Person-focused pay or competency-based pay rewards employees for specifically learning new curricula. Pay-for-knowledge plans reward managerial, service, or professional workers for successfully learning specific curricula (Chapter 5). Skill-based pay, used mostly for employees who perform physical work, increases these workers' pay as they master new skills (Chapter 5). Both skill- and knowledge-based pay programs reward employees for the range, depth, and types of skills or knowledge they are capable of applying productively to their jobs. This feature distinguishes pay-for-knowledge plans from merit pay, which rewards employees' job performance. Said another way, pay-for-knowledge programs reward employees for their potential to make meaningful contributions on the job.

EMPLOYEE BENEFITS Earlier, we noted that employee benefits represent nonmonetary rewards. Employee benefits include any variety of programs that provide paid time off, employee services, and protection programs. Companies offer many benefits on a discretionary basis. We refer to these as **discretionary benefits** (Chapter 9). In addition, the U.S. government requires most employers to provide sets of benefits to employees. We refer to these as **legally required benefits** (Chapter 10). Different forces led to the rise of legally required and discretionary employee benefits.

The first signs of contemporary discretionary benefits were evident in the late 1800s when large companies such as American Express offered pension plans to employees. Most of the development in employee benefits practice for the next few decades resulted from government legislation, as previously noted. Discretionary benefits offerings became more prominent in the 1940s and 1950s due in large part to federal government restrictions placed on increasing wage levels. Employee benefits were not subject to those restrictions.

Discretionary benefits fall into three broad categories: protection programs, paid time off, and services (Chapter 9). **Protection programs** provide family benefits, promote health, and guard against income loss caused by such catastrophic factors as unemployment, disability, or serious illness. Not surprisingly, **paid time off** provides employees with pay for time when they are not working (e.g., vacation). **Services** provide such enhancements as tuition reimbursement and day care assistance to employees and their families.

Legally required benefits historically provided a form of social insurance. Prompted largely by the rapid growth of industrialization in the United States during the late nineteenth and early twentieth centuries as well as the Great Depression of the 1930s, initial social insurance programs were designed to minimize the possibility of destitution for individuals who were unemployed or became severely injured while working. In addition, social insurance programs aimed to stabilize the well-being of dependent family members of injured or unemployed individuals. Further, early social insurance programs were designed to enable retirees to maintain subsistence income levels. These intents of legally required benefits remain intact today. The U.S. government has established programs to protect individuals from such catastrophic events as

disability and unemployment. Legally required benefits are exclusively protection programs that attempt to promote worker safety and health, maintain the influx of family income, and assist families in crisis. Many of the key legally required benefits are mandated by the Social Security Act of 1935, various state workers' compensation laws, the Family and Medical Leave Act of 1993, and the Patient Protection and Affordable Care Act of 2010 (PPACA). All provide protection programs to employees and their dependents (Chapter 10). It especially should be noted that until the passage of PPACA, employers offered health insurance as a discretionary benefit. Not only does this law require that employers provide health insurance, but it also exerts influence on the design of health insurance arrangements (Chapter 10).

Employers typically spend substantial amounts to pay employees and provide benefits. Table 1-2 lists these costs. ¹⁷ This table also includes the cost of wages and salaries based on a sample of occupations and industry types. The costs are expressed on an hourly basis per employee. For example, in September 2017, employers characteristically spent \$35.64 per employee per hour worked, including wages and salaries as well as benefits. Of this figure, \$24.33 was spent on wages and salaries and \$11.31 was spent on benefits (\$2.63 for legally required benefits and \$8.68 for discretionary benefits). All employee benefits costs account for 31.7 percent of total compensation costs.

Fundamental Compensation System Design Elements

Compensation professionals promote effective compensation systems by meeting three important goals: internal consistency, market competitiveness, and recognition of individual contributions, which corresponds to three important compensation system design elements.

INTERNAL CONSISTENCY Internally consistent compensation systems clearly define the relative value of each job among all jobs within a company. This ordered set of jobs represents the job structure or hierarchy. Companies rely on a simple, yet fundamental, principle for building internally consistent compensation systems: Employees in jobs that require greater qualifications, more responsibilities, and more complex job duties should be paid more than employees whose jobs require lesser qualifications, fewer responsibilities, and less-complex job duties. Internally consistent job structures formally recognize differences in job characteristics, which therefore enable compensation managers to set pay accordingly. For example, let's consider two related HR jobs that differ in job characteristics. According to the *Occupational Outlook Handbook*, the work of Human Resources Specialists and Labor Relations Specialists is described in the following manner:

Human resources specialists recruit, screen, interview, and place workers. They often handle other human resources work, such as those related to employee relations, payroll and benefits, and training. Labor relations specialists interpret and administer labor contracts regarding issues such as wages and salaries, employee welfare, healthcare, pensions, and union and management practices. ¹⁸

A Human Resources Manager's work is described in the following way:

Human resources managers plan, direct, and coordinate the administrative functions of an organization. They oversee the recruiting, interviewing, and hiring of new staff; consult with top executives on strategic planning; and serve as a link between an organization's management and its employees. ¹⁹

A comparison shows similarities (jobs that are focused on HR functions) and differences. The specialist roles are transactional (e.g., conducting job interviews) while the managerial roles include strategic considerations based on consultations with executives. The median annual pay for a specialist is \$59,180²⁰ and \$106,910 for the manager.²¹ The pay difference can be attributed, in large part, to the noted dissimilarities between the jobs and the roles they play relative to competitive strategy attainment.

TABLE 1-2 Employer Costs per Hours Worked for Employee Compensation, Civilian Workers^a

	Total Compensation	Wages and Salaries	AII Benefits	Paid Leave	Supplemental Pay	Insurance	Retirement and Savings	Legally Required Benefits
			Cos	t per hour	Cost per hour worked (in dollars)	(S		
Civilian Workers	35.64	24.33	11.31	2.51	1.10	3.11	1.96	2.63
Occupational Group								
Management, professional, and related	59.42	40.19	19.23	4.82	2.11	4.82	3.83	3.65
Sales and office	25.57	17.95	7.62	1.70	0.61	2.44	0.95	1.91
Natural resources, construction, and maintenance	36.35	24.30	12.05	1.97	1.05	3.38	2.20	3.45
Production, transportation, and material moving	28.48	18.78	9.70	1.71	1.00	3.01	1.35	2.63
Industry Group								
Goods-producing	40.00	26.51	13.49	2.59	1.49	3.74	2.34	3.32
Service	34.87	23.95	10.92	2.49	1.03	3.00	1.90	2.51

Source: U.S. Bureau of Labor Statistics (December 15, 2017). Employer costs for employee compensation, September 2017 (USDL: 17-1646). Available: https://www.bls.gov/news.release/pdf/ecec.pdf, accessed January 3, 2018. ^a Includes workers in the private nonfarm economy excluding households and the public sector excluding the federal government.

FYI

The increase in hourly compensation costs between 2007 and 2017 varied by compensation component:

Total Compensation: 23.4%
Wages and Salaries: 24.4%
Employee Benefits: 33.5%²²

Compensation professionals use job analysis and job evaluation to achieve internal consistency. **Job analysis** is a systematic process for gathering, documenting, and analyzing information to describe jobs. Job analyses describe content or job duties, worker requirements, and sometimes the job context or working conditions. For example, aerospace engineers design aircraft, spacecraft, satellites, and missiles. In addition, they test prototypes to make sure that they function according to design.²³ Aerospace engineers possess at least a bachelor's degree in aerospace engineering or another field of engineering or science related to aerospace systems. While some aerospace engineers work on projects that are related to national defense and thus require security clearances, others are employed in industries whose workers design or build aircraft, missiles, systems for national defense, or spacecraft.

Compensation professionals systematically use **job evaluation** to recognize differences in the relative worth among a set of jobs and to establish pay differentials accordingly. Whereas job analysis is almost purely descriptive, job evaluation partly reflects the values and priorities that management places on various positions. Based on job content differences (e.g., job analysis results) and the firm's priorities, managers establish pay differentials for virtually all positions within the company.

MARKET COMPETITIVENESS Market-competitive pay systems play a significant role in attracting and retaining the most qualified employees. Compensation professionals build market-competitive compensation systems based on the results of compensation surveys.

Compensation surveys collect and then analyze competitors' compensation data. Compensation surveys traditionally focused on competitors' wage and salary practices. Now, employee benefits are also a target of surveys because benefits are a key element of market-competitive pay systems. Compensation surveys are important because they enable compensation professionals to obtain realistic views of competitors' pay practices. In the absence of compensation survey data, compensation professionals would have to use guesswork to build market-competitive compensation systems.

RECOGNIZING EMPLOYEE CONTRIBUTIONS Pay structures represent pay rate differences for jobs of unequal worth and the framework for recognizing differences in employee contributions. No two employees possess identical credentials or perform the same jobs equally well. Companies recognize these differences by paying individuals according to their credentials, knowledge, or job performance. When completed, pay structures should define the boundaries for recognizing employee contributions. Well-designed structures should promote the retention of valued employees.

Pay grades and pay ranges are structural features of pay structures. Pay grades group jobs for pay policy application. Human resource professionals typically group jobs into pay grades based on similar compensable factors and value. These criteria are not precise. In fact, no single formula determines what is sufficiently similar in terms of content and value to warrant grouping into a pay grade. Pay ranges build upon pay grades. Pay ranges include minimum, maximum, and midpoint pay rates. The minimum and maximum values denote the acceptable lower and upper bounds of pay for the job's pay grades. The midpoint pay value is the halfway mark between the minimum and maximum pay rates.

Alternative Pay Structure Configurations

There are alternative pay structure configurations, which we will explore in this book. Each structure comes with its own set of challenges. These structures include:

- Merit pay plans (Chapter 8)
- Sales compensation plans (Chapter 8)
- Broadband structures (Chapter 8)
- Two-tier wage structures (Chapter 8)
- Executive compensation (Chapter 11)
- Contingent worker compensation (Chapter 12)
- Expatriate compensation (Chapter 13)
- Compensation structures in countries other than the United States (Chapter 14)

FITTING THE COMPENSATION FUNCTION IN AN ORGANIZATION'S STRUCTURE

1-5. Describe the fit of the compensation function in organizations.

Understanding compensation professionals' goals requires knowing the role of HR within companies and specific HR practices, particularly how HR professionals fit into the corporate hierarchy, and how the compensation function fits into HR departments.

How HR Professionals Fit into the Corporate Hierarchy

Line function and staff function broadly describe all employee functions. Line employees are directly involved in producing companies' goods or delivering their services. Assembler, production worker, and salesperson are examples of line jobs. Staff employees support those responsible for the line functions. Human resource professionals and accountants are examples of staff employees. Human resource professionals are staff employees because they offer a wide variety of support services for line employees. In a nutshell, HR professionals promote the effective use of all employees in companies. Effective use means attaining work objectives that fit with the overall mission of the company. According to Jay Hannah, BancFirst Corp. executive vice president of financial services, "The HR department is the source and keeper of critical information, which is key in today's workplace. With the information they provide, we in turn can build and design strategies to hire and retain the best workforce possible. And this may sound cliché, but it's very true—the real competitive advantage is our company's human resources." Line employees are directly incompany to those more professionals are examples of line jobs. Staff employees support those responsible for those examples of line jobs. Staff employees support those responsible for those examples of line jobs. Staff employees support those responsible for those examples of line jobs. Staff employees support those responsible for line in jobs. Staff employees support those responsible for line in jobs. Staff employees support those responsible for line in jobs. Staff employees support those responsible for line in jobs. Staff employees support those responsible for line in jobs. Staff employees support those responsible for line examples of line jobs. Staff employees support those responsible for line in jobs. Staff employees support those responsible for line in jobs. Staff employees are examples of line jobs. Staff employees in complex support those responsible for line in

Human resource professionals design and implement a variety of HR practices that advance this objective. In addition to compensation determination, HR practices include:

- Recruitment
- Selection
- · Performance appraisal
- Training
- Career development
- Labor-management relations
- Employment termination
- Managing HR within the context of legislation

Most company structures include an HR department. Traditionally, HR departments were thought of as an administrative or support function for the company because the financial or market value of HR was not as readily apparent as sales, manufacturing, or marketing functions. Some practitioners and researchers are suspect about the future of internal HR functions.

The Compensation Profession

Various designations are used within the human resource profession, in general, and in compensation, specifically. Among these are compensation executives, generalists, and specialists. An **executive** is a top-level manager who reports directly to the corporation's CEO or to the head of a major division. A **generalist**, who may be an executive, performs tasks in a variety of HR-related areas. The generalist is involved in several, or all, of the compensation functions such as building job structures, market competitive pay systems, and merit pay structures. A **specialist** may be an HR executive, manager, or non-manager who is typically concerned with only one of the areas of compensation practice. According to the *Occupational Outlook Handbook*, compensation and benefits managers do the following:

Compensation managers plan, direct, and coordinate how much an organization pays its employees and how employees are paid. Benefits managers plan, direct, and coordinate retirement plans, health insurance, and other benefits that an organization offers its employees.²⁵

Performance standards are established by members of the profession rather than by outsiders. Most professions also have effective representative organizations that permit members to exchange ideas of mutual concern. Several well-known organizations serve the profession. Among the more prominent for compensation professionals are the Society for Human Resource Management (http://www.shrm.org), the International Foundation of Employee Benefit Plans (http://www.ifebp.org), and WorldatWork (http://www.worldatwork.org).

Opportunities for employment as compensation and benefits managers are projected to grow at an annual rate of 5 percent through 2026.²⁶ The median annual compensation for Compensation and Benefits Managers was \$116,240,²⁷ which is more than double the median annual earnings for all jobs. The salary levels vary on a few factors, including relevant work experience, educational credentials, and industry. For example, annual compensation was lowest in local government (\$95,850) settings and highest in the insurance industry (\$126,940).



Additional jobs with compensation responsibilities and duties—Median Annual Pay and Projected Employment Growth/Decline (2016–2026):

- HR Specialists: \$59,180; 7% growth
- Compensation, Benefits and Job Analysis Specialists: \$62,080; 9% growth
- Labor Relations Specialists: \$62,310; 8% decline (due to decline in unionization)²⁸

How the Compensation Function Fits into HR Departments

Human resource practices do not operate in isolation. Every HR practice is related to others in different ways. For example, as an employer, U.S. federal government agencies publicly acknowledge the relationships between incentive compensation and other HR practices, including recruitment, relocation, and retention:

Recruitment: An agency may pay a recruitment incentive to a newly appointed career executive if the agency has determined that the position is likely to be difficult to fill in the absence of an incentive. A recruitment incentive may not exceed 25 percent of the executive's annual rate of basic pay in effect at the beginning of the service period multiplied by the number of years (including fractions of a year) in the service period (not to exceed 4 years).

Relocation: An agency may pay a relocation incentive to a current career executive who must relocate to accept a position in a different geographic area if the agency determines that the position is likely to be difficult to fill in the absence of an incentive. A relocation

incentive may be paid only when the executive's rating of record under an official performance appraisal or evaluation system is at least "fully successful" or equivalent. A relocation incentive may not exceed 25 percent of the executive's annual rate of basic pay in effect at the beginning of the service period multiplied by the number of years (including fractions of a year) in the service period (not to exceed 4 years).

Retention: An agency may pay a retention incentive to a current career executive if (1) the agency determines that the unusually high or unique qualifications of the executive or a special need of the agency for the executive's services makes it essential to retain the executive, and that the executive would be likely to leave the Federal service in the absence of a retention incentive, or (2) the agency has a special need for the employee's services that makes it essential to retain the employee in his or her current position during a period of time before the closure or relocation of the employee's office, facility, activity, or organization and the employee would be likely to leave for a different position in the Federal service in the absence of a retention incentive. A retention incentive may be paid only when the executive's rating of record under an official performance appraisal or evaluation system is at least "fully successful" or equivalent. A retention incentive rate, expressed as a percentage of the executive's rate of basic pay, may not exceed 25 percent.²⁹

Let's consider additional relationships between compensation and each of the HR practices.

COMPENSATION, RECRUITMENT, AND SELECTION Job candidates choose to work for companies for many reasons, including career advancement opportunities, training, the company's reputation for being a "good" place to work, location, and compensation. Companies try to spark job candidates' interest by communicating the positive features of the core compensation and employee benefits programs. As we will discuss in Chapter 7, companies use compensation to compete for the very best candidates. In addition, companies may offer such inducements as one-time signing bonuses to entice high-quality applicants. It is common for signing bonuses to amount to as much as 20 percent of starting annual salaries. Signing bonuses are useful when the supply of qualified candidates falls short of companies' needs for these candidates.

The next three sections will address performance appraisal, training, and career development. Before discussing these issues, however, let's first look at how the U.S. federal government explicitly acknowledges the relationship between compensation and these HR practices:

Chapter 43 of Title 5, United States Code, provides for performance management for the Senior Executive Service (SES), the establishment of SES performance appraisal systems, and appraisal of senior executive performance. Agencies establish performance management systems that hold senior executives accountable for their individual and organizational performance to improve the overall performance of Government by:

- Expecting excellence in senior executive performance;
- Linking performance management with the results-oriented goals of the Government Performance and Results Act of 1993;
- Setting and communicating individual and organizational goals and expectations;
- Systematically appraising senior executive performance using measures that balance organizational results with customer, employee, or other perspectives; and
- Using performance results as a basis for pay, awards, development, retention, removal and other personnel decisions.

Agencies develop performance management systems subject to Office of Personnel Management (OPM) regulations and approval.

The supervisor establishes performance elements and requirements in consultation with the executive and consistent with the goals and performance expectations in the agency's strategic planning initiatives. The supervisor proposes the initial summary rating, based on both individual and organizational performance, and considering customer satisfaction and employee perspective.³⁰

COMPENSATION AND PERFORMANCE APPRAISAL Accurate performance appraisals are integral to effective merit pay programs. For merit pay programs to succeed, employees must know that their efforts toward meeting production quotas or quality standards will lead to pay raises. Job requirements must be realistic, and employees must be prepared to meet job goals with respect to their skills and abilities. Moreover, employees must perceive a strong relationship between attaining performance standards and receiving pay increases. Merit pay systems require specific performance appraisal approaches. Administering successful merit pay programs depends as much on sound performance appraisal practices as it does on the compensation professional's skill in designing and implementing such plans.

COMPENSATION AND TRAINING Successful pay-for-knowledge plans depend on a company's ability to develop and implement systematic training programs. When training is well designed, employees should be able to learn the skills needed to increase their pay, as well as the skills necessary to teach and coach other employees at lower skill levels. Companies implementing pay-for-knowledge plans typically increase the amount of classroom and on-the-job training. Pay-for-knowledge systems make training necessary rather than optional. Companies that adopt pay-for-knowledge systems must accordingly ensure that all employees have equal access to the training needed to acquire higher-level skills.

COMPENSATION AND CAREER DEVELOPMENT Most employees expect to experience career development within their present companies. Employees' careers develop in two different ways. First, some employees change the focus of their work—for example, from supervisor of payroll clerks to supervisor of inventory clerks. This change represents a lateral move across the company's hierarchy. Second, others maintain their focus and assume greater responsibilities. This change illustrates advancement upward through the company's hierarchy. Advancing from payroll clerk to manager of payroll administration is an example of moving upward through a company's hierarchy. Employees' compensation changes to reflect career development.

COMPENSATION AND LABOR-MANAGEMENT RELATIONS Collective bargaining agreements describe the terms of employment (e.g., pay and work hours) reached between management and the union. Compensation is a key topic. Unions have fought hard for general pay increases and regular COLAs to promote their members' standard of living. In Chapter 2, we will review the role of unions in compensation, and in Chapter 3, we indicate that unions have traditionally bargained for seniority pay systems in negotiations with management. More recently, unions have been willing to incorporate incentive pay systems. For example, unions appear to be receptive to behavioral encouragement plans because improving worker safety and minimizing absenteeism serve the best interests of both employees and employers.

compensation and employee's agreement to perform work is terminated. Employment terminations are either involuntary or voluntary. The HR department plays a central role in managing involuntary employment terminations. Companies initiate involuntary terminations for a variety of reasons, including poor job performance, insubordination, violation of work rules, reduced business activity due to sluggish economic conditions, and plant closings. Discharge represents involuntary termination for poor job performance, insubordination, or gross violation of work rules. Involuntary layoff describes termination under sluggish economic conditions or because of plant closings. In the case of involuntary layoffs, HR professionals typically provide outplacement counseling to help employees find work elsewhere. Companies may choose to

award severance pay, which usually amounts to several months' pay following involuntary termination and, in some cases, continued coverage under the employer's medical insurance plan. Employees often rely on severance pay to meet financial obligations while they search for employment. In the past, companies commonly offered a year or more of severance pay. Severance benefits today tend to be less generous. For example, as part of Delta Air Lines' closure of its Boston reservation center, the company offered only 6 weeks of severance pay regardless of seniority with the company.

Employees initiate voluntary terminations, most often to work for other companies or to retire. In the case of retirement, companies sponsor pension programs. Pension programs provide income to individuals throughout their retirement. Companies sometimes use early retirement programs to reduce workforce size and trim compensation expenditures. Early retirement programs contain incentives designed to encourage highly paid employees with substantial seniority to retire earlier than they had planned. These incentives expedite senior employees' retirement eligibility and increase their retirement income.

COMPENSATION AND LEGISLATION Employment laws establish the bounds of both acceptable employment practices and employee rights. Federal laws that apply to compensation practices are grouped according to four themes:

- · Income continuity, safety, and work hours
- Pay discrimination
- Medical care and the accommodation of disabilities and family needs
- Prevailing wage laws

The federal government enacted income continuity, safety, and work hour laws (e.g., the Fair Labor Standards Act of 1938) to stabilize individuals' incomes when the individuals became unemployed because of poor business conditions or workplace injuries, as well as to set pay minimums and work-hour limits for children. The civil rights movement of the 1960s led to the passage of key legislation (e.g., the Equal Pay Act of 1963 and the Civil Rights Act of 1964) designed to protect designated classes of employees and to uphold their individual rights against discriminatory employment decisions, including matters of pay. Congress enacted legislation, namely, the Patient Protection and Affordable Care Act of 2010, the Pregnancy Discrimination Act of 1978, the Americans with Disabilities Act of 1990, and the Family and Medical Leave Act of 1993 to provide medical care and accommodate employees with disabilities and pressing family needs. Prevailing wage laws (e.g., the Davis–Bacon Act of 1931) set minimum wage rates for companies that provide paid services—such as building maintenance—to the U.S. government. We will review these laws in Chapter 2.

STAKEHOLDERS OF THE COMPENSATION SYSTEM

The HR department provides services to stakeholders within and outside the company. These include:

- Employees
- Line managers
- Executives
- Unions
- U.S. government

The success of HR departments depends on how well they serve various stakeholders. "Each constituency [stakeholder] has its own set of expectations regarding the personnel department's activities; each holds its own standards for effective performance; each applies its own standards for assessing the extent to which the department's activities meets its expectations;

1-6. Identify the stakeholders of the compensation function and summarize their stakes in the work compensation professionals perform.

and each attempts to prescribe preferred goals for the subunit or presents constraints to its sphere of discretion. Multiple stakeholders often compete directly or indirectly for the attention and priority of the personnel department."³¹ Our focus is on some of the ways compensation professionals serve these stakeholders.

Employees

As we discussed earlier, successful pay-for-knowledge programs depend on a company's ability to develop and implement systematic training programs. Compensation professionals must educate employees about their training options and how successful training outcomes will lead to increased pay and advancement opportunities within the company. These professionals should not assume that employees will necessarily recognize these opportunities unless they are clearly communicated. Written memos and informational meetings conducted by compensation professionals and HR representatives are effective communication media.

Discretionary benefits provide protection programs, paid time off, and services. As compensation professionals plan and manage employee benefits programs, they should keep these functions in mind. There is probably no single company that expects its employee benefits program to meet all these objectives. Compensation professionals as representatives of company management, along with union representatives, must therefore determine which objectives are the most important for their workforce.

Line Managers

Compensation professionals use their expert knowledge of the laws that influence pay and benefits practices to help line managers make sound compensation judgments. For example, the Equal Pay Act of 1963 (discussed in Chapter 2) prohibits sex discrimination in pay for employees performing equal work, so compensation professionals should advise line managers to pay the same hourly pay rate or annual salary for men and women hired to perform the same job.

Line managers turn to compensation professionals for advice about appropriate pay rates for jobs. Compensation professionals oversee the use of job evaluation to establish pay differentials among jobs within a company. In addition, they train line managers in how to evaluate jobs properly.

Executives

Compensation professionals serve company executives by developing and managing sound compensation systems. Executives look to them to ensure that the design and implementation of pay and benefits practices comply with pertinent legislation. Violation of these laws can lead to substantial monetary penalties to companies. Executives also depend on compensation professionals' expertise to design pay and benefits systems that will attract and retain the best-qualified employees.

Unions

As noted earlier, collective bargaining agreements describe the terms of employment reached between management and the union. Compensation professionals are responsible for administering the pay and benefits policies specified in collective bargaining agreements. They mainly ensure that employees receive COLAs and seniority pay increases on a timely basis.

U.S. Government

The U.S. government requires that companies comply with all employment legislation. Compensation professionals apply their expertise regarding pertinent legislation to design legally sound pay and benefits practices. In addition, since the passage of the Civil Rights Act of 1991, compensation professionals have applied their expertise to demonstrate that alleged discriminatory pay practices are a business necessity. As we will discuss in Chapter 2, the burden

of proof to demonstrate that alleged discriminatory pay practices are not discriminatory rests with compensation professionals.

DEVELOPING SKILLS FOR YOUR CAREER

1-7. Explore essential skills for developing your career in compensation or any other career path.

If you are not an HRM or business major, or you do not plan to take an assignment in the compensation function in the foreseeable future, you may be thinking that this section isn't relevant to you. Let me assure you, it is. Whether you plan on a career in the compensation field, the lessons you learn in this course will help you in business and in your life. Also, it is only through the aggregate of your educational experience that you will have the opportunity to develop many of the skills that employers have identified as critical to success in the workplace. In this course, and, specifically in this text, you'll have the opportunity to develop and practice seven important skills in the following ways: communication, critical thinking, collaboration, knowledge application and analysis, business ethics and social responsibility, information technology application and computing skills, and data literacy.

Communication

Communication is defined as effective use of oral, written, and nonverbal skills for multiple purposes (e.g., to inform, instruct, motivate, persuade, and share ideas); effective listening; using technology to communicate; and being able to evaluate the effectiveness of communication efforts—all within diverse contexts. The *Working Together* feature offers opportunities to collaborate through sharing ideas, listening to others' ideas, and coming up with a cohesive team response to the assignment. If assigned by your instructor, you may make brief oral presentations, creating an additional opportunity for working together. All the while, you will gain insight into your and your group members' strengths and weaknesses pertaining to communication (and collaboration) skills. Never pass up an opportunity to hone these skills.

Critical Thinking

Critical thinking involves purposeful and goal-directed thinking used to define and solve problems and to make decisions or form judgments related to a situation or set of circumstances. The *Discussion Questions* and *Crunch the Numbers* provide you with an excellent opportunity to think through concepts and their applications. *Crunch the Numbers* will also give you the chance to analyze quantitative data to facilitate problem solving. Analysis of the *Cases*, which depict realistic scenarios that you will likely encounter in the workplace, requires your interpretation and an actionable response. Similarly, you will have the chance to think through and discuss your responses to common *Ethics Dilemmas*. More about the ethics dilemmas shortly. Critically thinking about situations is just one part of the story.

Collaboration

Collaborative learning takes place in a situation in which individuals actively work together on a task, constructing meaning and knowledge as a group through dialogue and negotiation resulting in a final product reflective of joint, interdependent actions. I've already made the case for *Working Together*. Your professor may similarly ask you to analyze *Cases* in small groups. Another feature, *Compensation in Action*, explains how HR professionals and managers throughout the organization work together to address important workplace issues. This feature highlights the connections between managers and compensation professionals, and the reality that work is rarely performed in isolation.

Knowledge Application and Analysis

Knowledge application and analysis is defined as the ability to learn a concept and then appropriately apply that knowledge in another setting to achieve a higher level of understanding. All the activities discussed in this section provide you with multiple opportunities to think through solutions to specific problems and generalize these processes to other situations you will likely encounter in the future. Two additional features further help you develop this skill. *Try It* directs you to mini simulations and, in *Watch It*, you will review video clips that require a response to important workplace challenges. If your instructor assigns it, the accompanying *Building Strategic Compensation Systems* case will enable you to determine the best strategic compensation design for company success.

Business Ethics and Social Responsibility

Business ethics are sets of guiding principles that influence the way individuals and organizations behave within the society that they operate. Two additional issues require everyone's attention. The first, corporate social responsibility, is the implied, enforced, or felt obligation of managers, acting in their official capacity, to serve or protect the interests of groups other than themselves. Second, corporate sustainability focuses on the possible future impact of an organization on society, including social welfare, the economy, and the environment. Both issues are like ethics; however, ethics also focuses on individual decision making and behavior as well as the impact of ethical choices on employee welfare. The *Ethics Dilemma*, presented in the end-of-chapter material, will keep these important matters in the forefront as you move ahead in your career.

Information Technology Application and Computing Skills

Information technology application and computing skills are defined as the ability to select and use appropriate technology to accomplish a given task. The individual is also able to apply computing skills to solve problems. *Crunch the Numbers* gives you the opportunity to develop these skills. Also, if your instructor chooses to have you complete the accompanying *Building Strategic Compensation Systems Case*, you will have the opportunity to become familiar with the power of Microsoft Excel for analyzing copious amounts of compensation data.

Data Literacy

Data literacy is the ability to access, assess, interpret, manipulate, summarize, and communicate data. Throughout this book, the newly created feature titled *FYI* provides tidbits of information from survey research and extensive databases (e.g., weekly pay statistics) that illuminate trends, opinions, and the use of specific compensation practices. Also, particularly in Chapters 6, 7, and 8, you will be challenged to quantify and interpret the value of jobs based on the knowledge, skills, and abilities required to perform them, analyzing and interpreting market pay rates to establish pay ranges, and merit pay increase grids to determine the appropriate pay increase based on performance as well as the budgetary implications of your choices. You also can build your data literacy by completing the *Crunch the Numbers* exercises and the *Building Strategic Compensation Systems* case. Altogether, these data should enable you to translate quantitative information for placement into the employment context. Further, you can expand this skill by thinking through when and how to create new policies or modify existing ones.

In summary, you will find opportunities throughout this book to develop several critical skills that provide a foundation of success on any career path that you follow. As you learn about compensation systems, consider how you can generalize these skills to other workplace situations. Best of luck whether you are preparing for the start of your career or are in the process of changing career paths!

PREPARING FOR EXAMS/QUIZZES

MyLab Management

Go to www.pearson.com/mylab/management to complete the problems marked with this icon \(\bigota \).



Chapter Summary by Learning Objectives

Learning Objective 1-1. Define strategic compensation. Strategic compensation refers to the design and implementation of compensation systems to reinforce the objectives of both HR strategies and competitive business strategies. The building blocks of strategic compensation include extrinsic compensation (monetary compensation or core compensation as well as nonmonetary compensation or employee benefits).

Learning Objective 1-2. Summarize the role of compensation as a strategic business partner. Compensation professionals must think like the Chief Executive Officer (CEO) to become a partner in achieving organizational plans and results. Compensation professionals help leverage the value of employees (human capital) for competitive advantage based on the design and use of various compensation practices, including merit pay and incentive pay.

Learning Objective 1-3. Explain strategic compensation decisions. Compensation professionals design compensation systems to meet the imperatives of two competitive business strategy types: lowest cost strategy and differentiation strategy. Success comes with being able to answer yes to each of three questions: (1) Does compensation strategy fit well with the objectives of competitive business and HR strategies? (2) Does the choice and design of compensation practices fit well to support compensation strategy? (3) Does the implementation of compensation practices effectively direct employee behavior to enhance job performance that supports the choice of compensation practices?

Learning Objective 1-4. Identify and discuss the building blocks and structural elements of strategic compensation systems. The building blocks of compensation systems

include core compensation and employee benefits. The elements of compensation systems focus on achieving internally consistent job structures, market-competitive pay systems, and alternative pay structures that recognize employee contributions.

Learning Objective 1-5. Describe the fit of the compensation function in organizations. Fitting compensation into an organization's structure requires consideration of how compensation professionals fit into the corporate hierarchy, how compensation fits into HR departments, and the relationship between compensation practice and other HR functions (e.g., recruitment and training).

Learning Objective 1-6. *Identify the stakeholders of* the compensation function and summarize their stakes in the work compensation professionals perform. The HR department provides services to the several stakeholders: employees, line managers, executives, unions, and the U.S. government. Compensation professionals serve these stakeholders in different ways. For example, compensation professionals educate employees about their training options and how successful training outcomes will lead to increased pay and advancement opportunities.

Learning Objective 1-7. Explore essential skills for developing your career in compensation or any other career path. Whether you are embarking on a career in compensation or another path, there are seven essential skills needed for success: communication, critical thinking, collaboration, knowledge application and analysis, business ethics and social responsibility, information technology application and computing skills, and data literacy.

Key Terms

competitive advantage 3 compensation intrinsic compensation extrinsic compensation 3 core compensation 3 employee benefits competitive business strategy human resources strategies 4 strategic compensation 5 capital 5 human capital 5 cost leadership (lowest-cost strategy) 7 differentiation strategies 7 base pay 9 hourly pay or wage 9

compensable factors 9 cost-of-living adjustments 9 seniority pay 9 human capital theory merit pay 10 incentive pay 10 variable pay 10 person-focused pay 10 competency-based pay pay-for-knowledge 10 skill-based pay 10 discretionary benefits 10 legally required benefits protection programs 10 paid time off 10 services 10

systems 11 job analysis 13 job evaluation 13 market-competitive pay systems 13 compensation surveys 13 pay structures 13 pay grades 13 pay ranges 13 line employees staff employees 14 executive 15 generalist 15 specialist severance pay pension programs 18 early retirement programs 18

internally consistent compensation

MyLab Management

CHAPTER QUIZ!

annual salary 9

If your professor has assigned this, go to the Assignments section of www.pearson.com/mylab/management to complete the Chapter Quiz! and see what you've learned.

Discussion Questions

- **1-1.** What are the main building blocks of compensation systems? Briefly describe each one.
- **1-2.** How can compensation professionals serve as strategic business partners?
- 1-3. Are the three main structural elements of compensation systems—internal consistency, market competitiveness, and recognizing employee contributions—equally important, or do you believe that they differ in importance? Explain.
- **1-4.** The compensation profession is expected to grow at a healthy pace through the year 2026. Based

- on your understanding of how the chapter material blends together, what might be some reasons for this anticipated growth? Explain.
- 1-5. Stakeholder expectations pose challenges for compensation professionals. At times, there may be conflict among the expectations of different stakeholders. For two stakeholders, how do compensation professionals meet their expectations?
- **1-6.** How are the seven employability skills relevant regardless of your career aspirations?

PREPARING FOR MY CAREER

Compensation in Action

Consistent, innovative, and fair compensation practices are central to ensuring the success of both human resource strategies and overall company competitive strategies. While it is HR's role to decide what kind of people are critical to fill roles that will lead to successful execution of competitive strategies, compensation

professionals must align practices that will enable attraction, appropriate job placement, and development of these individuals. Many companies have moved from the personnel management model to the HR business partner model; however, some still look to HR to guarantee that policies are being enforced and the company mitigates legal risk. Depending on the company where you are employed—and whether you are a line manager or HR professional—you may find yourself able to understand the competitive strategy of the business and align compensation practices with the strategic thrust of the business.

Action checklist for line managers and HR—aligning compensation with strategy

HR takes the lead

- Work with line managers to fully understand which roles and types of employees will best support
 the execution of company strategy.
- Collaborate with compensation specialists to run analysis of market factors (competitors, industry standards, local labor market) to get indicators of compensation norms and standards to keep your company's compensation practices competitive.
- Create, together with line managers, pay structures wherein roles are placed into appropriate pay
 grades. Each grade will have a corresponding range that will serve as the basis for assigning pay rates
 for roles.

Line managers take the lead

- Educate staff positions, along with other business leaders, for all to understand what strategy is being
 employed to achieve specific company objectives.
- Educate HR on certain aspects of roles (e.g., autonomy, skill variety, task significance, etc.) that, when enhanced, could improve intrinsic motivation, thus leading to benefits for employees and employers. HR works on ways to couple the intrinsic compensation with the identified plan for the core compensation plan.
- Work together with HR to implement a plan that ties the compensation plan to a successful recruitment, training, and development plan, ensuring that the company is retaining the talent that is critical to the implementation and delivery of the strategic objectives.

Cases

🚷 An additional Supplemental Case can be found on MyLab Management.

Case 1: Competitive Strategy at Sportsman Shoes

Sportsman Shoes has been a leader in the shoe industry for more than 30 years. Sportsman manufactures and sells athletic shoes for all types of sports. The company has pursued a low-cost strategy to sustain its success. It sells a limited number of shoe designs and has held costs low through manufacturing efficiency and standardized operations. However, the past years have been a struggle at Sportsman. The shoe market has seen a rise in the availability of low-cost imported shoes that has threatened Sportsman's competitive position. As a result, company executives have decided it is time for a strategy shift.

Sportsman executives have done extensive market research and determined that many niche athletic shoe markets exist where athletes are willing to pay more for shoes designed to meet the unique needs of their sport. There are very few competitors in these niche athletic shoe markets, and most do not have Sportsman's experience in keeping control of manufacturing costs. Sportsman has determined that, with talented shoe designers in place, they can manufacture athletic shoes to meet the needs of the niche markets using their current manufacturing facilities and employees. By designing shoes that have features that differ from competitors and meet the specific needs of a new group of customers, Sportsman believes the company can create a competitive advantage. Further, while their shoes will not be as low cost as they were in the past, they will likely be able to sell their shoes for less than market competitors and still make a healthy profit.

Therefore, Sportsman has decided to shift from its current low-cost strategy to a differentiation strategy and will begin production to make specialty athletic shoes. Sportsman must now make many tactical decisions in various functional areas of the company to support its decision to shift its overall business strategy.

Its priority is to restructure the product development function. As it will need to understand the needs of the niche markets and design shoes to meet those needs, it will need to hire and retain talented shoe designers. The company will also need to hire operations specialists to transition its manufacturing operations to produce the new shoe designs. Beyond hiring new staff, Sportsman also must consider the implications for current employees to help them successfully transition to their new work requirements. Therefore, there are several considerations the company must address in human resource management.

Questions:

- **1-7.** Following Sportsman's shift in competitive strategy, what are some considerations for the company's human resource management practices?
- **1-8.** What kinds of challenges will Sportsman face specifically in compensation?

Case 2: Ethics Dilemma: Profits at Any Cost

Since 2006, more than 5,000 Wells Fargo bank employees opened 2 million bank accounts for customers who did not request them. The bank's leadership claimed that the employees acted on their own volition, and they were subsequently fired. Many current and past employees claimed that Wells Fargo raised daily sales goals to unrealistic levels, creating a high-pressure environment in which to earn their sales commissions and keep their jobs. Other employees talked about how managers regularly asked them about their progress, focusing exclusively on the number of accounts opened rather than discussing appropriate sales techniques that could help employees legitimately meet their quotas. When goals were not met, many employees alleged that they were threatened with formal written warnings and termination.

Indeed, many employees used fraudulent sales tactics to meet their sales quotas out of fear of receiving a bad employment reference. Others expressed that they could not afford to earn less sales commission (essentially, a pay cut) let alone be unemployed even for a brief time. Apparently, employees who called the company's ethics line to report their concerns were punished or fired. Even branch managers felt the pinch. Allegedly, high-ranking bank officials ordered employees to shred documents before auditor inspections.

Questions:

- **1-9.** As a compensation professional, what would you do?
- **1-10.** What factor(s) in this ethical dilemma might influence a person to make a less-than-ethical decision?

© Crunch the Numbers!

Calculating the Costs of Increasing the Total Compensation Budget at Butcher Enterprises

An additional Crunch the Numbers! exercise can be found on www.pearson.com/mylab/management.

Butcher Enterprises has experienced substantial employee turnover among its office workers. During exit interviews, more than 80 percent stated that low pay was the top reason for resigning. The company conducted a survey of local companies' pay practices to confirm whether this concern is valid. Indeed, Butcher Enterprises' average hourly pay rate for total compensation falls well below the market. The compensation survey showed an average hourly rate of \$23 for total compensation. Of this amount, wages are \$16 per hour and benefits are \$7 per hour. In comparison, Butcher Enterprises spends an average hourly rate of \$19 for total compensation. Of this amount, 70 percent is allocated for wages.

Questions:

- **1-11.** On an average hourly basis, how much does Butcher Enterprises spend on wages and benefits, respectively, in dollars?
- **1-12.** How much does the company spend on wages and benefits over the course of one year for 100 office workers? Assume that each worker provides 2,080 hours of service each year.
- **1-13.** How much additional money does the company need to match the market rates for this group of 100 employees?

Working Together: Team Exercise

In small groups of three or four, come up with specific answers to the following questions. Talk through your perspectives and come up with a team response. Be prepared to share your ideas with the class.

As a group, think about retailers from which you make purchases for products or services (for example, purchasing an iPhone or Apple Music streaming service). Select two retailers—one that you believe follows a lowest cost strategy and another that follows a differentiation strategy that sell iPhones. In addition, conduct some research to identify what you believe to be one threat or one opportunity for each company. Please do not use the companies included as examples in this chapter.

Questions:

- **1-14.** What is the rationale for the companies you chose? Explain. (*Hint: Compare your choices with alternative retailers to help formulate your rationale.*)
- **1-15.** In what way is the opportunity or threat that you identified for each company likely to affect competitive advantage? Explain.

MyLab Management

Go to **www.pearson.com/mylab/management** for Auto-graded writing questions as well as the following Assisted-graded writing questions:

- 1-16. Explain the similarities and differences between merit pay, incentive pay, and person-focused pay. Explain the role of performance appraisals in merit pay programs.
- 1-17. Discuss how compensation professionals contribute to a firm's competitive advantage.
- 1-18. MyLab Management Only—comprehensive writing assignment for this chapter.

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Contextual Influences on Compensation Practice

Learning Objectives

When you finish studying this chapter, you should be able to:

- **2-1.** Discuss the reasons for interindustry wage differentials.
- **2-2.** Explain the factors that contribute to pay differentials based on occupational characteristics.
- **2-3.** Summarize the reasons for the occurrence of geographic pay differentials.
- **2-4.** Discuss the role of labor unions in setting compensation.
- **2-5.** Identify and discuss key employment laws pertinent to compensation practice.

CHAPTER WARM-UP!

If your professor has assigned this, go to the Assignments section of www.pearson.com/mylab/management to complete the Chapter Warm-Up! and see what you already know. After reading the chapter, you'll have a chance to take the Chapter Quiz! and see what you've learned.

In Chapter 1, we discussed strategic compensation. That discussion revealed that compensation professionals plan, develop, and implement compensation practices to help achieve competitive advantage. From this perspective, it is imperative that compensation professionals understand the broader context in which compensation decisions are rendered. Compensation professionals should understand the patterns of pay differentials outside their companies to help make informed decisions about fair and competitive pay practices. Also, with these data, they may make compelling requests to the Chief Financial Officer (CFO) for monetary resources necessary to appropriately fund compensation programs for competitive advantage. These factors include interindustry wage differentials, occupational pay differentials, geographic pay differentials, and the role of labor unions. We will present basic statistical information to illustrate these differentials as well as discuss possible explanations for them.

Besides these various patterns of pay differentials, compensation professionals make decisions within the scope of pertinent employment and labor relations laws to maintain compliance with government mandates, and, in doing so, protecting the welfare of employees and serving the interests of company shareholders. Employment and labor relations laws are essential to maintain a balance of power between employers and employees. In a nutshell:

The freedom to contract is crucial to freedom of the market; an employee may choose to work or not to work for a given employer, and an employer may choose to hire or not to hire a given applicant. As a result, the employment relationship is regulated in

some important ways. Congress tries to avoid telling employers how to manage their employees. . . . However, Congress has passed employment-related laws when it believes that the employee is not on equal footing with the employer. For example, Congress has passed laws that require employers to pay minimum wages and to refrain from using certain criteria, such as race or gender, in arriving at specific employment decisions. These laws reflect the reality that employers stand in a position of power in the employment relationship. Legal protections granted to employees seek to make the power relationship between employer and employee one that is fair and equitable. \(^1\)

In this regard, compensation professionals strive to establish and maintain a fair pay-effort bargain (that is, appropriate pay for performing work according to standard), and to collaborate with managers and supervisors to ensure that employee performance is appropriately rewarded over time.

It should be noted that compensation professionals operate in a global context in which compensation practices may require modification to attract and retain employees on important international assignments. Also, it is necessary to understand the role governments and cultural values in other countries play in compensation practices. The global stage presents an important contextual factor. We will address those issues in Chapters 13 and 14.

INTERINDUSTRY WAGE DIFFERENTIALS

Are equivalent workers performing similar work paid more in some industries than in others? Most often, the answer is *yes*. In a competitive labor market, companies attempt to attract and retain the best individuals for employment partly by offering lucrative wage and benefits packages. Some companies are unable to compete with companies in other industries based on wage and benefits because of persistent interindustry wage differentials. **Interindustry wage differentials** represent the pattern of pay and benefits associated with characteristics of industries. Interindustry wage differentials can be attributed to many factors, including the industry's product market, the degree of capital intensity, the profitability of the industry, and unionization of the workforce.² The basis for interindustry wage differentials will be explained shortly. Table 2-1 displays the average weekly earnings in various industries for select years between 2009 and 2017. Utilities and mining establishments generally pay the highest wages; retail trade and leisure and hospitality establishments generally pay the lowest wages. In 2016, for instance, general office clerks who were employed in the coal mining industry earned an hourly wage, on average, of \$18.39. In the full-service restaurant industry, the average hourly wage was \$14.56.³

Companies that operate in product markets where there is relatively little competition from other companies tend to pay higher wages because these companies generally exhibit substantial profits. This phenomenon can be attributed to factors such as higher barriers to enter into the product market and virtually have no influence of foreign competition. Government regulation and extremely expensive heavy or robotic equipment represent entry barriers. The U.S. defense industry and the public utilities industry have high entry barriers and virtually no threats from foreign competitors.

Capital intensity refers to the extent to which companies' operations are based on the use of large-scale equipment. Capital intensity also explains pay differentials between industries. The amount of average pay varies with the degree of capital intensity. On average, capital-intensive industries (e.g., manufacturing) pay more than industries that are less capital intensive (e.g., retail). Capital-intensive businesses require employees who have the aptitude to learn how to use complex physical equipment such as casting machines and robotics. Workers usually receive on-the-job training, sometimes including employer-sponsored technical instruction. In addition, some employers may require specialized training or an associate's degree for the most skilled assembly and fabrication jobs. Employment settings include automotive assembly, aircraft engine assembly, and ship building.

2-1. Discuss the reasons for interindustry wage differentials.

Industry	2009 (\$)	2011 (\$)	2013 (\$)	2015 (\$)	2017 (\$) ^a
Utilities	1,366	1,385	1,474	1,530	1,649
Mining	1,180	1,276	1,276	1,365	1,492
Construction	911	988	1,010	1,049	1,149
Manufacturing	885	969	976	1,022	1,161
Retail trade	478	506	516	541	572
Leisure and hospitality	329	338	348	372	410

TABLE 2-1 Average Weekly Earnings by Industry Group, Select Years 2009–2017

Source: U.S. Bureau of Labor Statistics. The Employment Situation—December 2017. Available: http://www.bls.gov, accessed January 8, 2018; U.S. Bureau of Labor Statistics. Employment, Hours, and Earnings. Data Retrieval. Available: www.bls.gov/webapps/legacy/cesbtab3.htm, accessed February 13, 2015.

Service industries such as retail are not capital intensive, and most have the reputation of paying low wages. The operation of service industries depends almost exclusively on employees with relatively common skills. Most retail sales workers receive on-the-job training, which usually lasts a few days to a few months.

Furthermore, companies in profitable industries tend to pay higher compensation, on average, than companies in less profitable industries. Employees in profitable industries presumably receive higher pay because their skills and abilities contribute to companies' success and are more productive; however, as more companies have failed to meet financial goals over the past few years, they have struggled with how best to pay for performance.

As we will discuss shortly, companies in highly unionized industries tend to pay higher wages, on average, than do companies in lesser unionized industries. In general, the power of collectively negotiating employment terms, including pay, is greater than the negotiating power of a single individual. Employees' right to strike could cripple not only their employer, but also hurt companies that rely on receiving raw materials or finished goods.

For instance, in 2016, 36,000 Verizon employees walked off the job after negotiations with management failed. Outsourcing jobs was one of the main reasons for workers' decision to strike. At the time, the U.S. Bureau of Labor Statistics indicated that the Verizon strike was the largest number of employees to strike in a single company. A strike halts production, resulting in lost customers and revenue, which the union hopes will force management to submit to its terms. In Korea, Hyundai workers conducted 21 partial strikes in 2016 that caused a production loss of about 117,000 vehicles, costing the company more than \$2.5 billion.

Some strikes can have far-reaching consequences for other firms and their customers. For example, when port workers on the west coast went on strike, many cargos ships were prohibited from reaching port and thousands of empty transport trucks remained empty. Many firms ranging from car dealers to retail companies experienced dwindling inventories of imported goods and the inability to serve all customer demand. The following Watch It! video briefly describes the Los Angeles port strike and its effects.

WATCH IT!

If your professor has assigned this, go to the Assignments section of www.pearson.com/mylab/management to complete the video exercise.

At the same time, most highly unionized industries (e.g., manufacturing, construction, and mining) are capital intensive, requiring employees with the aptitude to learn and use complex production technology such as the cranes and hoists for loading and unloading massive cargo containers.

^a 2017 figures are for December.

PAY DIFFERENTIALS BASED ON OCCUPATIONAL CHARACTERISTICS

An **occupation** is a group of jobs, found at more than one company, in which a common set of tasks are performed or are related in terms of similar objectives, methodologies, materials, products, worker actions, or worker characteristics. File clerk, clerk typist, administrative clerk, staff secretary, and administrative secretary are jobs in the office support occupation. Compensation analyst, training and development specialist, recruiter, and benefits counselor are jobs in the human resources management occupation. Considerable variation in pay *between occupations* can be explained by the complexity of knowledge, skills, and abilities (KSAs) that define jobs (for example, surgeons and building service workers). Another important factor is the labor market dynamics of the supply and demand for qualified employees.

workers). Another important factor is the labor market dynamics of the supply and demand for qualified employees.

Pay variations can also be observed *within occupations*, based on the complexity of KSAs associated with different jobs that define an occupation, and we will look at some examples shortly. It should be noted that references to differences in KSAs or relative worth of different jobs are based exclusively on job content and demand for individuals who possess the required KSAs. These references *do not* convey value judgments about the worth of these jobs in soci-

KNOWLEDGE, SKILLS, AND ABILITIES In Chapter 6, we will address the role of *job analysis* to provide detailed descriptions of jobs based on differing combinations of KSAs. Typically, jobs that are based on knowledge and skills, which are developed based on formal education (vocational education, college education) or early job experiences such as internships or apprenticeships (for example, in the cases of medical doctors or plumbers, respectively) are highly valued as measured by pay levels. Jobs with less specialized or complex KSAs are typically paid much less.

ety or to the value placed on the people who hold different jobs. The same applies to pay level

references.

Let's consider one job from the health care practitioners and technical operations occupation and one from the office and administrative support occupation. According to the *Occupational Outlook Handbook*, anesthesiologists focus on the care of surgical patients and on pain relief. They also work outside of the operating room, providing pain relief in the intensive care unit, during labor and delivery, and for those who suffer from chronic pain. Anesthesiologists work with other physicians and surgeons to decide on treatments and procedures before, during, and after surgery. Preparation for becoming an anesthesiologist requires advanced training that includes completion of medical school, internships, residencies, and attaining medical board certification. In May 2016, the average annual salary was \$269,600.

According to the *Occupational Outlook Handbook*, secretaries and administrative assistants usually answer telephones and take messages or transfer calls, schedule appointments and update event calendars, arrange staff meetings, handle incoming and outgoing mail and faxes, draft routine memos, billing, or other reports, and maintain databases and filing systems. Typically, high school graduates who have basic office and computer skills qualify for entrylevel positions. Most secretaries learn their job in several weeks. In May 2016, the average annual salary was \$40,330.9

Pay differences are also evident within occupations because of different job requirements. Let's consider pharmacist and pharmacist technician jobs, which are part of the health care occupation. According to the *Occupational Outlook Handbook*, ¹⁰ pharmacists possess advanced training to give them the knowledge and skills to safely fill prescriptions, verify instructions from physicians on the proper amounts of medication to give to patients, check whether the prescription will interact negatively with other drugs that a patient is taking or any medical conditions the patient has, instruct patients on how and when to take a prescribed medicine, and inform them about potential side effects they may experience from taking the medicine. Pharmacy

2-2. Explain the factors that contribute to pay differentials based on occupational characteristics.

technicians support the work of pharmacists while under their supervision. For example, technicians take the information needed to fill a prescription from customers or health professionals, measure amounts of medication for prescriptions, package and label prescriptions, and organize inventory. Pharmacy technicians do not require advanced education; most of their training takes place on the job. Average annual pay reflects these differences. In 2016, pharmacists earned \$120,270 while pharmacy technicians earned \$32,170. 11

SUPPLY AND DEMAND Companies' demand for qualified individuals for jobs relative to supply often influences compensation. There are upward pressures to raise starting pay when the demand for qualified workers jobs is greater than supply. These market dynamics require that companies compete for limited numbers of qualified workers. This appears to be the case for information security analysts. According to the Occupational Outlook Handbook, 12 demand for information security analysts is expected to be much higher than supply. The Center for Cyber Safety and Education estimates that there will be 1.8 million unfilled jobs by 2022, which represents a 20 percent rise from the 1.5 million unfilled jobs in 2015. ¹³ Cyberattacks have grown in frequency and sophistication over the last few years, and many organizations are behind in their ability to detect these attacks. For instance, the credit bureau Experian experienced a breach of their databases that contained customers' information to determine credit worthiness. Nearly 150 million records were unlawfully accessed by the hackers. Thus, analysts will be needed to come up with innovative solutions to prevent hackers from stealing critical information or creating havoc on computer networks. Also, the federal government is expected to greatly increase its use of information security analysts to protect the nation's critical information technology (IT) systems. Further, as the health care industry expands its use of electronic medical records, ensuring patients' privacy and protecting personal data are becoming more important. More information security analysts are likely to be needed to create the safeguards that will satisfy patients' concerns.



Both private-sector companies and the federal government are competing for cyber security talent; however, the difference in annual pay between the government and private sector is staggering, particularly for chief information officer jobs:

Private-sector: \$500,000 to \$2,000,000
 Federal government: \$123,175 to \$185,100¹⁴

Two major factors are contributing to a shortage of commercial airline pilots—airlines' increasing the size of their fleets and an expected 42 percent of current pilots are expected to retire by 2027. The shortage of commercial airline pilots is expected to swell to 20,000 by 2022. The shortage of commercial airline pilots is expected to swell to 20,000 by 2022. This trend weighs heavily on most airlines. Greg Muccio, a senior manager at Southwest Airlines Company lamented: "That is one of the things in my job I get to worry about every day and when I got to bed at night." And he sees an overall lack of interest in becoming a commercial pilot as a key problem: "That's what puts us in the most jeopardy." There are many factors that may be contributing to this lack of interest. Most commercial pilots spend the first several years working for regional airlines where annual pay has been traditionally quite low—in the \$20,000 range. Eventually, many of these airlines doubled starting pay. Still, raising pay has done little to move the needle. The cost of flight-training is quite high, surpassing the \$100,000 mark after factoring in the cost of tuition and living expenses. And, recent tighter government regulation requires substantially more flight hours and other experience, typically, at lower paying jobs, before becoming eligible for co-pilot positions at commercial airlines.