BARRY GERHART | JERRY M. NEWMAN

Compensation

THIRTEENTH EDITION

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Compensation

Thirteenth Edition

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McGraw Hill Education

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Preface

You can't read a news article or blog today without someone talking about compensation (wages/salaries, but also benefits like health care and retirement). Compensation is uniquely important in organizations because it typically represents the single largest operating cost, especially where employee skills or human capital are the source of competitive advantage (e.g., Google/Alphabet, Facebook; investment banking, law, accounting, and consulting firms; professional sports teams; universities). Compensation is also important because employees regularly report it as the most important factor that goes into their decision of whether to take a job or stay in a job. Compensation also plays a major role in what employees choose to do on the job: their effort level, where they direct their effort/what goals they pursue, how cooperative they are, how flexible they are, how ethical they are, and so forth. These all add up to determine how efficient, innovative, customer-oriented and (in the case of for-profit) how profitable an organization is over time. Profits, in turn, create jobs. In the absence of profits, jobs disappear. An organization that pays too much, pays too little, ties too much compensation up as fixed costs, and/or pays for the wrong things puts the company, its investors, and its employees at risk. On the other hand, designing and executing an effective compensation strategy can play a key role in great shared success.

Compensation challenges ebb and flow with changes in the economy. The Financial Crisis of 2008 and the related Great Recession brought job cuts (with the national unemployment rate rising to 10 percent, the highest since 1983), reduced hours, reduced employer contributions to 401(k) retirement plans, reduced bonus/profit-sharing payments, and some wage cuts. With revenue and profits down and with labor costs often the single largest operating cost, employers cut labor costs in these ways. The Great Recession also focused attention on executive compensation. As the government bailed out the financial industry, newspapers were reporting large bonuses going to the very executives who helped cause the financial disaster. Eventually, as company revenues picked up again, we gradually saw employers put less emphasis on cutting labor costs and more emphasis on hiring. However, job growth was initially quite modest. At the beginning of 2013, the unemployment rate was still at 8 percent. Why? Employers have become increasingly careful about adding new workers because they want to keep costs under control and they don't want to have to reduce the workforce if they guess wrong about increasing revenue growth/product demand (and the need for more workers). But competition for some types of workers has increased and wages, salaries, and benefits have likewise increased for such workers, meaning that employers must continually evaluate and benchmark their pay to be competitive. As economic growth has continued, competition for employees has increased and the U.S. unemployment rate is now under 4 percent, the lowest it has been since 1969. However, as we will see, wage gains remain modest. That is because employers are careful not only about hiring, as we have noted. They are also careful about giving wage/salary increases because once those are added to base pay, "they are there forever." Increasingly, employers seek to make labor costs variable, which means greater reliance on bonuses and/or profit-sharing, where payments to employees go up during good times, but automatically go down during bad times when profits and revenues are down.

Pay also matters around the globe. To take a (bit light) example, if you were a Russian cosmonaut, you could earn a bonus of $1,000 for every space walk you took (technically known as "extravehicular activity"), up to three per space trip. A contract listing specific tasks to be done on a space mission permits you to earn up to $30,000 above the $20,000 you earn while you are on the ground. Conclusion: *Pay matters.*

(As a small aside, in contrast to the Russian cosmonauts, wealthy Americans had the opportunity to pay many millions to the Russian Space Agency for their own personal extravehicular activity. More recently, Elon Musk's company, SpaceX, has announced planned trips not only to the moon, but also to Mars. Musk is aiming for a cost of $200,000 per person, but some of his projections in the past have not been completely accurate.)

After you have read this book, you will also better understand that *what you pay for matters.* Many years ago, when Green Giant discovered too many insect parts in the pea packs from one of its plants, it designed a bonus plan that paid people for finding insect parts. Green Giant got what it paid for: insect parts. Innovative Green Giant employees brought insect parts from home to add to the peas just before they removed them and collected the bonus.

The Houston public school district also got what it paid for when it promised teachers bonuses of up to $6,000 if their students' test scores exceeded targets. Unfortunately, several teachers were later fired when it was discovered that they had leaked answers to their students and adjusted test scores. Teachers were motivated to raise test scores, just not to raise them in the way desired (improved student learning). Wells Fargo wanted customers to sign up for more of its products to increase its potential for revenue and profit growth. To achieve this goal, Wells Fargo incentivized its employees so they would be rewarded for achieving this goal (and/or penalized if they did not achieve it). This incentive certainly "worked," if you think this includes employees setting up fake accounts, which the customers did not sign up for, in order to achieve their targets for performance (new account sign-ups). Again, employees were motivated to achieve the outcome, but not necessarily in the appropriate way.[1]

Such problems are global. A British telephone company paid a cash bonus to operators based on how quickly they completed requests for information. Some operators discovered that the fastest way to complete a request was to give out a wrong number or—even faster—just hang up on the caller. "We're actually looking at a new bonus scheme," says an insightful company spokesperson. Conclusion: *What you pay for matters.*

After you have read this book, you will also have learned that *how you pay matters.* Motorola ended its old-fashioned pay system that employees said guaranteed a raise every six months if you were still breathing. The new system paid for learning new skills and working in teams. Sound good? It wasn't. Employees resented those team members who went off for six weeks of training at full pay while remaining team members picked up their work. Motorola was forced to get rid of its new-fashioned system, too.

[1] E. Glazer, "Wells Fargo to Roll Out New Compensation Plan to Replace Sales Goals: Bankers Say Previous Lofty Goals Pushed Them to Open Accounts without Customers' Knowledge," *Wall Street Journal,* January 6, 2017.

Wells Fargo also, not surprisingly, had to change *how* it pays and *what* it pays for.[2] Specific changes made include:

- No product sales goals.
- Performance evaluation based on customer service, usage and growth, not simply on new accounts opened.
- Incentives associated with direct customer feedback and product usage.
- A higher percentage of employee compensation comprised of base salary, rather than variable incentives.
- More employee performance metrics focused on the goals of a given bank branch, instead of on an individual worker.

To summarize, compensation is a powerful tool that has major consequences for the success or failure of an organization. Our aim is to put you in a better position to design and/or execute compensation strategies to make success more likely. That will be helpful whatever the scale and scope of your responsibility, from a unit of a few employees to an entire organization. Our book will also help you better understand how your own compensation is managed and how that can help you achieve your own career goals.

ABOUT THIS BOOK

This book focuses on the strategic choices in managing compensation. We introduce these choices, real-world issues that managers confront from New York to New Zealand and all points between, in the total compensation model in Chapter 1. This model provides an integrating framework that is used throughout the book. Major compensation issues are discussed in the context of current theory, research, and practice. The practices illustrate new developments as well as established approaches to compensation decisions.

We live in interesting times. Anywhere you look on the globe today, economic and social pressures are forcing managers to rethink how people get paid and what difference it makes. Traditional approaches to compensation are being questioned. But what is being achieved by all this experimentation and change? What is merely fad and fashion, and what, instead, is supported by the evidence? In this book, we strive to separate beliefs from facts, wishful thinking from demonstrable results, and opinions from research. Yet when all is said and done, managing compensation is part science, but also part art.

Each chapter contains at least one *e-Compensation box* to point you to some of the vast compensation information on the Internet. Real-life *Your Turn* cases ask you to apply the concepts and techniques discussed in each chapter. For example, the Your Turn in Chapter 9 draws on Professor Newman's experience when he worked undercover for 14 months in seven fast-food restaurants. The case takes you into the gritty details of the employees' behaviors (including Professor Newman's) during rush hour, as they desperately worked to fill customers' orders and meet their own performance targets set by their manager. You get to recommend which rewards will improve employees' performance (including Professor Newman's) and customers' satisfaction. We tackle major compensation issues from three sides: theory, research, and practice—no problem can survive that onslaught!

[2] Kevin McCoy, "Wells Fargo Revamps Pay Plan after Fake-Accounts Scandal," *USA Today,* January 11, 2017.

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

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

WHAT'S NEW

All chapters have been revised, in recognition of ongoing changes at organizations and in their competitive environments around the world. Many examples are provided of the current pay strategies or practices used in specific, named companies. Some of these are well established and successful (Apple, IBM, Microsoft, Merrill Lynch, Nucor, Toyota), some face real problems (American Airlines, Best Buy, General Motors), and others are using unique practices (Google, Whole Foods). Whenever possible, we observe how the challenges faced by these companies have evolved over time. This edition continues to emphasize the importance of total compensation and its relevance for achieving sustainable competitive advantage. It reinforces our conviction that beyond *how much* people are paid, *how* they are paid really matters. Managing pay means ensuring that the right people get the right pay for achieving objectives in the right way. Greater emphasis is given to theoretical advances and evidence from research. Throughout the book we translate this evidence into guidance for improving the management of pay.

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A very special thanks goes to **George T. Milkovich**, who was the lead author on the first 11 editions of *Compensation*. George has long been our mentor, colleague, and friend. His influence on us and on *Compensation* continues.

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Part One

Introducing the Pay Model and Pay Strategy

Why do we work? If we are fortunate, our work brings meaning to our lives, challenges us in new and exciting ways, brings us recognition, and gives us the opportunity to interact with interesting people and create friendships. Oh yes—we also get a paycheck. Here in Part 1 of your book, we begin by talking about what we mean by "pay" and how paying people in different ways can influence them and, in turn, influence organization success. Wages and salaries, of course, are part of compensation, but so too, for some employees, are bonuses, health care benefits, stock options, and/or work/life balance programs.

Compensation is one of the most powerful tools organizations have to influence their employees. Managed well, it can play a major role in organizations successfully executing their strategies through their employees. We will see how companies like Whole Foods, Nucor, the SAS Institute, Microsoft, Google, and others use compensation to attract, motivate, and retain the right employees to execute their strategies. We will also see how companies like Apple sell premium products at attractive price points, to an important degree by using suppliers that have low labor costs. When they are managed less well—as bankruptcies at General Motors, Chrysler, Lehman Brothers, and American Airlines (which stated at the time that it needed to reduce labor costs by $1.25 billion per year to be competitive), for example, might indicate—compensation decisions can also come back to haunt you. In Part 1, we describe the compensation policies and techniques that organizations use and the multiple objectives they hope to achieve by effectively managing these compensation decisions.

Although compensation has its guiding principles, we will see that "the devil is in the details"—how a compensation program is specifically designed and implemented will help determine its success. We want you to bring a healthy skepticism when you encounter simplistic or sweeping claims about whether a particular way of managing compensation does or does not work. For example, organizations, in general, benefit from pay for performance, but there are many types of pay-for-performance programs, and it is not always easy to design and implement a program that has the intended consequences (and avoids *unintended* consequences). So, general principles are helpful, but only to a point.

Thus, in Part 1, our aim is to also help you understand how compensation strategy decisions interact with the specific context of an organization (e.g., its business and human resource strategies) to influence organization success. We emphasize that good theory and research are fundamental, not only to understanding compensation's likely effects, but also to developing that healthy skepticism we want you to have toward simplistic claims about what works and what does not.

Chapter **One**

The Pay Model

Chapter Outline

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

Why should you care about compensation? Do you find that life goes more smoothly when there is at least as much money coming in as going out? (Refer, for example, to the lyrics for the Beatles' song "Money."[1] To exaggerate a bit, they say something like: Money doesn't buy everything, but if money can't buy it, I can't use it.) Of course, it is the same for companies. It really does help to have as much money coming in (actually, more is better) as going out. Until recently, production workers at Chrysler received total compensation (i.e., wages plus benefits) of about $76 per hour. U.S. workers doing the same jobs at Toyota received $48 per hour, and the average total compensation per hour in U.S. manufacturing was $25 (and $16 in Korea, $3 in Mexico). It is one thing to pay more than your competitors if you get something more (e.g., higher productivity and/or quality) in return. But Chrysler was not. So its "strategy" was not sustainable. Chrysler ended up going through bankruptcy, being bought out by Fiat, and then reducing worker compensation costs as part of its strategy for a return to competitiveness. Specifically, Chrysler took steps (as part of its bankruptcy plan) to bring its hourly labor costs down to about $49.[2]

General Motors (GM), like Chrysler, has for decades paid its workers well—too well, perhaps, for what it received in return. So what? Well, in 1970, GM had 150 U.S. plants and 395,000 hourly workers. In sharp contrast, GM now has 35 U.S. manufacturing plants and 57,000 U.S. hourly workers.[3] In June 2009, GM, like Chrysler, had to file for bankruptcy (avoiding it for a while thanks to loans from the U.S. government—i.e., you, the taxpayer). Not all of GM's problems were compensation related. Building too many vehicles that consumers did not want was also a problem. But having labor costs higher than the competition's, without corresponding advantages in efficiency, quality, and customer service, does not seem to have served GM or its stakeholders well. Its stock price peaked at $93.62/share in April 2000. Its market value was about $60 billion in 2000. That shareholder wealth was wiped out in bankruptcy. Think also of the billions of dollars the U.S. taxpayer had to put into GM. Think of all the jobs that have been lost over the years and the effects on communities that have lost those jobs.

On the other hand, Nucor Steel pays its workers very well, relative to what other companies inside and outside of the steel industry pay. But Nucor also has much higher productivity than is typical in the steel industry. The result: Both the company and its workers do well. Apple Computer is able to reduce the prices for its iPads and iPhones by outsourcing manufacturing to China in facilities owned by the Hon Hai Precision Industry Co., Ltd. (Foxconn), a Taiwanese company. (See Chapter 7.) As we will see later, doing so generates billions (yes, billions with a "b") of dollars in cost savings per year. Google and Facebook are companies that are known for paying very well. So far that seems to have worked, in that their high pay allows them to be very selective in who they hire and who they keep, and they would say that their talent-rich strategy has helped them to foster growth and innovation.

Wall Street financial services firms and banks used **incentive** plans that rewarded people for developing "innovative" new financial investment vehicles and for taking risks to earn a lot of money for themselves and their firms.[4] But several years ago, the markets discovered that many such risks had gone bad. Blue chip firms such as Lehman Brothers slid quickly into bankruptcy, whereas others, like Bear Stearns and Merrill Lynch, survived to varying degrees by finding other firms (J.P. Morgan and Bank of America, respectively) to buy them. The issue has not gone away. U.S. Federal Reserve officials have "made it clear that they believe bad behavior at banks goes deeper than a few bad apples and are advising firms to track warning signs of excessive risk taking and other cultural breakdowns." In the words of one Fed official, "Risk takers are drawn to finance like they are to Formula One racing." An important driver of risk taking among traders and others is the incentive system that encourages them to be "confident and aggressive" and that often results in those who thrive under this incentive rising to top leadership positions at the banks.[5]

Does greater expertise in the design and execution of compensation plans help control excessive risk taking and other problematic behaviors and encourage a more positive culture? Congress and the president seemed to think so, because in hopes of avoiding a similar financial crisis in the future they put into place legislation—the Troubled Asset Relief Program (TARP)—that included restrictions on executive pay that were designed to discourage executives from taking "unnecessary and excessive risks." One commentator agreed. In an opinion piece in *The Wall Street Journal,* entitled "How Business Schools Have Failed Business," the former director of corporate finance policy at the United States Treasury argued that misaligned incentives were a major cause of the global financial crisis (see above) and wondered how many of the business schools that educated top executives and directors included a course on how to design compensation systems. His answer: not many.[6] Our book, we hope, can play a role in helping to better educate you, the reader, about the design of compensation systems, both for managers and for workers.

How people are paid affects their behaviors at work, which affect an organization's success.[7] For most employers, compensation is a major part of total cost, and often it is the single largest part of operating cost. These two facts together mean that well-designed compensation systems can help an organization achieve and sustain competitive advantage. On the other hand, as we have recently seen, poorly designed compensation systems can likewise play a major role in undermining organization success.

COMPENSATION: DEFINITION, PLEASE

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

Society

Some people see pay as a measure of justice. For example, a comparison of earnings between men and women highlights what many consider inequities in pay decisions. In 2016, U.S. Bureau of Labor Statistics data indicated that, among full-time workers in the United States, women earned 82 percent of what men earned, up from 62 percent in 1979.[8] If women had the same education, experience, and union coverage as men and also worked in the same industries and occupations, the ratio would increase, but most evidence suggests that no more than one-half of the gap would disappear. Thus, even under such a best-case scenario the ratio of women's earnings to men's would be about 90 percent, still leaving a sizable gap.[9] Society has taken an interest in such earnings differentials. One indicator of this interest is the introduction of laws and regulations aimed at eliminating the discrimination that causes them.[10] (See Chapter 17.)

Benefits given as part of a total compensation package may also be seen as a reflection of equity or justice in society. Civilian employers spend about 46 cents for benefits on top of every dollar paid for **wages** and **salaries.** (State and local government employers pay even more: 60 cents in benefits on top of every wage dollar.)[11] Individuals and businesses in the United States spend $3.5 trillion per year, or about 18 percent of U.S. economic output (gross domestic product) on health care.[12] Nevertheless, 27.6 million people in the United States (over 8 percent of the population) have no health insurance.[13] (Prior to implementation of The Affordable Care Act of 2010, 44 million were uninsured.)[14] A major reason is that the great majority of people who are under the age of 65 and not below the poverty line obtain health insurance through their employers, but small employers, which account for a substantial share of employment, are much less likely than larger employers to offer health insurance to their employees. As a result, the great majority of uninsured in the United States are from working families. (Of the uninsured, 85 percent have a full-time worker in the family and another 11 percent have a part-time worker in the family.)[15] Given that those who do have insurance typically have it through an employer, it also follows that whenever the unemployment rate increases, health care coverage declines further. (Some users of online dating services provide information on their employer-provided health care insurance. Dating service "shoppers" say they view health insurance coverage as a sign of how well a prospect is doing in a career.)

Job losses (or gains) within a country over time are partly a function of relative labor costs (and productivity) across countries. People in the United States worry about losing manufacturing jobs to Mexico, China, and other nations. (Increasingly, white-collar work in areas like finance, computer programming, and legal services is also being sent overseas.) Exhibit 1.1 reveals that hourly compensation (wages plus benefits) for Mexican manufacturing work ($3.91) is about 10 percent of the compensation paid in the United States ($36.34). China's estimated $5.45 per hour is about 14 percent of the U.S. rate. However, the value of what is produced also needs to be considered. Productivity in China is 24 percent of that of U.S. workers, whereas Mexican worker productivity is 34 percent of the U.S. level. Finally, if low wages are the goal, there always seems to be somewhere that pays less. Some companies (e.g., Coach) are now moving work out of China because its hourly wage, especially after recent increases, is not as low as in countries like Vietnam, India, and the Philippines. However, for other companies—such as Foxconn, which builds iPhones and iPads for Apple—even with rapid increases in wages in China, labor costs remain very low in China compared to those in the United States and other advanced economies. Foxconn appears to be poised to continue having a larger presence in China.[16] (More recently, Foxconn has also announced it will build a major new presence in southeast Wisconsin. Reasons include proximity to the U.S. market, as well as major incentives provided by the State of Wisconsin. We return to the topic of international comparisons in Chapter 7 and Chapter 16.)

EXHIBIT 1.1 Hourly Compensation Costs for Production Workers in Manufacturing and Economy-Wide Productivity (Gross Domestic Product [GDP] per Employed Person), in U.S. Dollars

	Hourly Compensation Cost	Productivity (GDP per employee)
China	5.45	27,196
Mexico	3.91	38,306
Czech Republic	10.71	65,467
United States	39.03	113,922
Germany	43.18	89,309

Source: "Hourly Compensation Cost: The Conference Board. International Comparisons of Hourly Compensation Costs in Manufacturing, 2016," February 16, 2018. Productivity (projected for 2017): The World Bank, http://data.worldbank.org/indicator/SL.GDP.PCAP.EM.KD, retrieved March 15, 2018.

Notes: Compensation includes wages and benefits. The most recent Conference Board compensation cost was $4.11 (in 2013) for China. The 2016 estimate for China was obtained by inflating the Conference Board estimates based on data on annual average wage growth in urban units from the China Statistical Yearbook, Table 4-12, National Bureau of Statistics of China. Productivity is gross domestic product (GDP), in constant 2011 PPP $, divided by total employment in the economy. Purchasing power parity (PPP) GDP is GDP converted to 2011 constant international dollars using PPP rates. (As such, these GDP per employee numbers are higher than past estimates using 1990 constant international dollars using PPP rates.) An international dollar has the same purchasing power over GDP that a U.S. dollar has in the United States.

Some consumers know that pay increases often lead to price increases. They do not believe that higher labor costs benefit them. But other consumers lobby for higher wages. While partying revelers were collecting plastic beads at New Orleans' Mardi Gras, filmmakers were showing video clips of the Chinese factory that makes the beads. In the video, the plant manager describes the punishment (5 percent reduction in already low pay) that he metes out to the young workers for workplace infractions. After viewing the video, one reveler complained, "It kinda takes the fun out of it."[17]

Stockholders

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

Stockholders (also called shareholders) have a particular interest in executive pay.[18] (Executive pay will be discussed further in Chapter 14.)[19] To the degree that the interests of executives are aligned with those of shareholders (e.g., by paying executives on the basis of company performance measures such as shareholder return), the hope is that company performance will be higher. There is debate, however, about whether executive pay and company performance are strongly linked in the typical U.S. company.[20] In the absence of such a linkage, concerns arise that executives can somehow use their influence to obtain high pay without necessarily performing well. Exhibit 1.2 provides descriptive data on chief executive officer (CEO) compensation. Note the large numbers (total annual compensation of $11.5 million) and also that the bulk of compensation (stock-related) is connected to shareholder return or other (primarily short-term, or one year or less) performance measures (bonus). As such, one would expect changes in CEO wealth and shareholder wealth to generally be aligned. We will return to this topic in more depth in Chapter 14.

EXHIBIT 1.2 **Annual Compensation of Chief Executive Officers, U.S. (S&P 500) Public Companies**

	Median
Compensation Component	
Salary	$ 1,200,000
Bonus	$ 2,100,000
Perquisites	$ 171,000
Stock Awards	$ 5,800,000
Stock Option Awards	$ 666,000
Total Annual Compensation	$11,700,000

Source: The Associated Press. How AP and Equilar Calculated CEO Pay. AP News, May 26, 2018. https://apnews.com/a3d216dc488347b8b9b23651b5f08e31

Notes: $N = 339$ chief executive officers in that role for at least two years at an S & P 500 company. Because medians are used, compensation components do not add up to equal total annual compensation.

In Chapter 14 we will suggest that, on average, CEO interests and shareholder interests appear to be significantly aligned, but there are important exceptions and it is certainly an ongoing challenge to ensure that executives act in the best interest of shareholders. For example, during the meltdown in the financial services industry, top executives at Bear Stearns and Lehman Brothers regularly exercised stock options and sold stock during the period 2000–2008 prior to the meltdown. One estimate is that these stock-related gains plus bonus payments generated $1.4 billion for the top five executives at Bear Stearns and $1 billion for those at Lehman Brothers during the 2000–2008 period. "Thus, while the long-term shareholders in their firms were largely decimated, the executives' performance-based compensation kept them in positive territory." The problem here is that shareholders paid a huge penalty for what appears to have been overly aggressive risk-taking by executives, but the executives, in contrast, did quite well because of "their ability to claim large amounts of compensation based on short-term results."[21]

Shareholders can influence executive compensation decisions in a variety of ways (e.g., through shareholder proposals and election of directors in proxy votes). In addition, the Dodd–Frank Wall Street Reform and Consumer Protection Act (see Chapter 14) was signed into law in 2010. Among its provisions is "say on pay," which requires public companies to submit their executive compensation plan to a vote by shareholders. The vote is not binding. However, companies seem to be intent on designing compensation plans that do not result in negative votes. In addition, clawback provisions (designed to allow companies to reclaim compensation from executives in some situations) are available under Dodd-Frank and have also been adopted in stronger form by some companies.[22]

Managers

For managers, compensation influences their success in two ways. First, it is a major expense that must be managed. Second, it is a major determinant of employee attitudes and behaviors (and thus, organization performance). We begin with the cost issue. Competitive pressures, both global and local, force managers to consider the affordability of their compensation decisions. Labor costs can account for more than 50 percent of total costs. In some industries, such as financial or professional services and in education and government, this figure is even higher. However, even within an industry, labor costs as a percentage of total costs vary among individual firms. For example, small neighborhood grocery stores, with labor costs between 15 percent and 18 percent, have been driven out of business by supermarkets that delivered the same products at a lower cost of labor (9 percent to 12 percent). Supermarkets today are losing market share to the warehouse club stores such as Sam's Club and Costco, which enjoy an even lower cost of labor (4 percent to 6 percent), even though Costco pays wages that are above average for the industry. And, now Amazon has entered the grocery business by purchasing Whole Foods, which is expected to cause further cost reductions and disruption.

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

EXHIBIT 1.3 **Pay Rates at Retail Stores, Customer Satisfaction, Employee Turnover, and Sales/Square Ft.**

	Average Pharmacy Tech Annual Wage	Average Stocker Hourly Wage	Average Cashier Hourly Wage	Customer Satisfaction (100 = highest)	Employee Annual Turnover	On Best Employer List?	Stores	Revenues	Store Size Average (Sq. ft.)	Number of Employees	Revenue per (Sq. ft.)	Revenues per Employee
Costco	$ 45,239	$13.00	$14.00	83	lower	Yes[b]	741	$126 billion	144,804	239,000	$1,176	$528,033
Sam's Club		$11.00[a]	$10.00	80			660	$ 57 billion	133,333	—	$ 652	—
Walmart	$ 29,352	$10.00	$9.00	71	higher	No	11,035	$424 billion	97,508	—	$ 394	—
Walmart + Sam's Club							11,695	$481 billion	99,530	2,300,000	$ 414	$209,268

Sources: Customer Satisfaction data from American Customer Satisfaction Index TM, http://www.theacsi.org/, retrieved March 27, 2017; Annual Turnover after 4 Years from Liza Featherstone, "Wage against the Machine," *Slate*, June 27, 2008; Number of Stores, Revenues, Store Size, Number of Employees from Wal-Mart 2017 10-K (Annual Report) and Costco 2017 10-K (Annual Report); Average Wage from www.glassdoor.com, retrieved March 27, 2017.

[a]Estimated.
[b]#1 on Forbes list.

with Sam's Club being a "warehouse store" with especially low prices on a narrower range of products, often times sold in bulk. Costco also competes on the basis of low prices, but with a mix that includes more high-end products aimed at a higher customer income segment. To compete in this segment, Costco appears to have chosen to pay higher wages, perhaps as a way to attract and retain a higher quality workforce.[23] A Costco's annual report states, "With respect to expenses relating to the compensation of our employees, our philosophy is not to seek to minimize the wages and benefits that they earn. Rather, we believe that achieving our longer-term objectives of reducing employee turnover and enhancing employee satisfaction requires maintaining compensation levels that are better than the industry average for much of our workforce." By comparison, Walmart simply states in its annual report that they "experience significant turnover in associates [i.e., employees] each year."[24] Based on Exhibit 1.3, Costco is quite successful, relative to its competitors, in terms of employee retention, customer satisfaction, and the efficiency with which it generates sales (see revenue per square foot and revenue per employee). So, although Costco's labor costs are higher than those of Sam's Club and Walmart, it appears that this model works for Costco because it helps it gain an advantage over its competitors.

Thus, rather than treating pay only as an expense to be minimized, a manager can also use it to influence employee behaviors and to improve the organization's performance. High pay, as long as it can be documented to bring high returns through its influences on employees, can be a successful strategy. As our Costco (versus Sam's Club and Walmart) example seems to suggest, the way people are paid affects the quality of their work and their attitude toward customers.[25] It may also affect their willingness to be flexible, learn new skills, or suggest innovations. On the other hand, people may become interested in unions or legal action against their employer based on how they are paid (e.g., if they perceive their pay to be unfairly low). This potential to influence employees' behaviors, and subsequently the productivity and effectiveness of the organization, means that the study of compensation is well worth your time, don't you think?[26]

Employees

The pay individuals receive in return for the work they perform and the value they create is usually the major source of their financial security. Hence, pay plays a vital role in a person's economic and social well-being. Employees may see compensation as a *return in an exchange* between their employer and themselves, as an **entitlement** for being an employee of the company, as an incentive to decide to take/stay in a job and invest in performing well in that job, or as a reward for having done so. Compensation can be all of these things.[27]

The importance of pay is apparent in many ways. Wages and benefits are a major focus of labor unions' efforts to serve their members' interests. (See Chapter 14.) The extensive legal framework governing pay—including minimum wage, living wage, overtime, and nondiscrimination regulations—also points to the central importance of pay to employees in the employment relationship. (See Chapter 17.) Next, we turn to how pay influences employee behaviors.

Incentive and Sorting Effects of Pay on Employee Behaviors

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

However, pay can also have an indirect, but important, influence via a **sorting effect** on the composition of the workforce.[28] That is, different types of pay strategies may cause different types of people to apply to and stay with (i.e., self-select into) an organization. In the case of pay structure/level, it may be that higher pay levels help organizations attract more high-quality applicants, allowing them to be more selective in their hiring. Similarly, higher pay levels may improve employee retention. (In Chapter 7, we will talk about when paying more is most likely to be worth the higher costs.)

Less obviously, perhaps, it is not only how much but *how* an organization pays that can result in sorting effects.[29] Ask yourself: Would people who are highly capable and have a strong work ethic and an interest in earning a lot of money prefer to work in an organization that pays about the same amount to all employees doing the same job, regardless of their performance? Or would they prefer to work in an organization where their pay can be much higher (or lower) depending on how they perform? If you chose the latter answer, then you believe that sorting effects matter. People differ regarding which type of pay arrangement they prefer. The question for organizations is simply this: Are you using the pay policy that will attract and retain the types of employees you want? Keep in mind that high performers have more alternative job opportunities and that more opportunities, all else being equal (e.g., if they are not paid more for their higher performance), translate into higher turnover—which is likely to be a significant problem if it is the high performers who are leaving, especially if high performers in particular roles create a disproportionately high amount of value for organizations.[30] This also raises the issue of dealing with outside offers that employees receive. We know that a substantial share of employee turnover results from receiving unsolicited outside offers. In other words, turnover is not always in response to dissatisfaction. Sometimes it is driven by opportunity. These are likely to be some of the most valuable employees, and thus policies and practices for dealing with outside offers (hopefully informed by research) are important.[31]

Let's take a look at one especially informative study conducted by Edward Lazear regarding incentive and sorting effects.[32] Individual worker productivity was measured before and after a glass installation company switched one of its plants from a salary-only (no pay for performance) system to an individual incentive plan under which each employee's pay depended on his/her own performance. An overall increase in plant productivity of 44 percent was observed comparing before and after. Roughly one-half of this increase was due to individual employees becoming more productive. However, the remaining one-half of the productivity gain was not explained by this fact. So, where did the other one-half of the gain come from? The answer: Less-productive workers were less likely to stay in their jobs under the new individual incentive system because it was less favorable to them. When they left, they tended to be replaced by more-productive workers (who were happy to have the chance to make more money under a system that rewards performance than they might make elsewhere). Thus, focusing only on the incentive effects of pay (on current workers) can miss the other major mechanism (sorting) by which pay decisions influence employee behaviors.

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

Global Views—*Vive la Différence*

In English, *compensation* means something that counterbalances, offsets, or makes up for something else. However, if we look at the origin of the word in different languages, we get a sense of the richness of the meaning, which combines entitlement, return, and reward.[33]

In China, the traditional characters for the word "compensation" are based on the symbols for logs and water, suggesting that compensation provides the necessities in life. In the recent past the state owned all Chinese enterprises, and compensation was treated as an entitlement. In today's China, compensation takes on a more subtle meaning. A new word, *dai yu,* is used. It refers to how you are being treated—your wages, benefits, training opportunities, and so on. When people talk about compensation, they ask each other about the *dai yu* in their companies. Rather than assuming that everyone is entitled to the same treatment, the meaning of compensation now includes a broader sense of returns as well as entitlement.[34]

"Compensation" in Japanese is *kyuyo,* which is made up of two separate characters (*kyu* and *yo*), both meaning "giving something." *Kyu* is an honorific used to indicate that the person doing the giving is someone of high rank, such as a feudal lord, an emperor, or a samurai leader. Traditionally, compensation is thought of as something given by one's superior. Today, business consultants in Japan try to substitute the word *hou-syu,* which means "reward" and has no associations with notions of superiors. The many allowances that are part of Japanese compensation systems translate as *teate,* which means "taking care of something." *Teate* is regarded as compensation that takes care of employees' financial needs. This concept is consistent with the family, housing, and commuting allowances that are still used in many Japanese companies.[35]

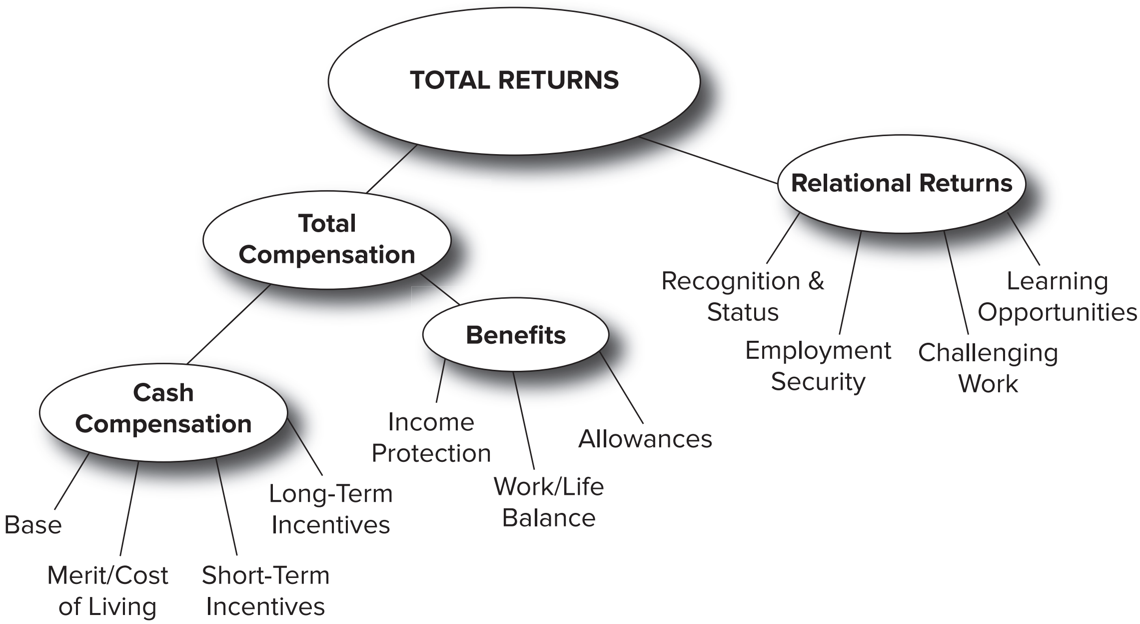
These contrasting ideas about compensation—multiple views (societal, stockholder, managerial, employee, and even global) and multiple meanings (returns, rewards, entitlement)—add richness to the topic. But they can also cause confusion unless everyone is talking about the same thing. So let's define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

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

FORMS OF PAY

Exhibit 1.4 shows the variety of returns people receive from work. Total returns are categorized as **total compensation** and **relational returns.** The relational returns (learning opportunities, status, challenging work, and so on) are psychological.[36] Total compensation returns are more transactional. They include pay received directly as cash (e.g., base, merit, incentives, cost-of-living adjustments) and indirectly as benefits (e.g., pensions, medical insurance, programs to help balance work and life demands, brightly colored uniforms).[37] So pay comes in different forms, and programs to pay people can be designed in a wide variety of ways. WorldatWork has a Total Rewards Model that is similar and includes compensation, benefits, work-life, performance/recognition, and development/career opportunities.[38] The importance of monetary rewards as a motivator relative to other rewards (e.g., intrinsic rewards such as how interesting the work is) has long been a topic of interest, as have the conditions under which money is more or less important to people (and even whether money is sometimes too important to people).[39] Although scholars and pundits have sometimes debated which is more important (and have sometimes argued that money does not motivate or even that it demotivates), our reading of the research indicates that both types of rewards are important and that it is usually not terribly productive to debate which is more important.[40] It will no doubt come as little surprise that we will focus on monetary rewards (total compensation) in a book called *Compensation.* Whatever other rewards employees value, it is our experience that they expect to be paid for their work, that how and how

EXHIBIT 1.4 **Total Returns for Work**



much they are paid affects their attitudes, performance, and job choice, as well as their standard of living. These effects of compensation on employees (as well as the cost of employee compensation) have major implications for how successfully organizations can execute their strategies and achieve their goals, as we will see.

Cash Compensation: Base

Base wage is the cash compensation that an employer pays for the work performed. Base wage tends to reflect the value of the work or skills and generally ignores differences attributable to individual employees. For example, the base wage for machine operators may be $20 an hour. However, some individual operators may receive more because of their experience and/or performance. Some pay systems set base wage as a function of the skill or education an employee possesses; this is common for engineers and schoolteachers.[41]

A distinction is often made in the United States between wage and salary, with **salary** referring to pay for employees who are **exempt** from regulations of the Fair Labor Standards Act (FLSA) and hence do not receive overtime pay.[42] Managers and professionals usually fit this category. Their pay is calculated at an annual or monthly rate rather than hourly, because hours worked do not need to be recorded. In contrast, workers who are covered by overtime and reporting provisions of the Fair Labor Standards Act—*nonexempts*—have their pay calculated as an hourly wage. Some organizations, such as IBM, Eaton, and Walmart, label all base pay as "salary." Rather than dividing employees into separate categories of salaried and wage earners, they believe that an "all-salaried" workforce reinforces an organizational **culture** in which all employees are part of the same team. However, merely changing the terminology does not negate the need to comply with the FLSA.

Cash Compensation: Merit Increases/Merit Bonuses/COLAs

A cost of living adjustment (COLA) to base wages may be made on the basis of changes in what other employers are paying for the same work, changes in living costs, or changes in experience or skill. Such provisions are less common than in the past as employers continually try to control fixed costs and link pay increases to individual and/or company performance.

Merit increases are given as increments to base pay and are based on performance.[43] According to a WorldatWork survey, 94 percent of U.S. firms use merit pay increases.[44] Given that 22 percent of respondents to the survey were in the nonprofit, not-for-profit, or public sectors where we know that the use of merit pay is less,[45] it may be that nearly 100 percent of U.S. private sector organizations use merit pay. Merit payments are based on an assessment (or rating) of recent past performance made (with or without a formal performance evaluation). In recent years, merit increase budgets (or average merit increases) have been around 3 percent.[46] Survey data indicate that, on average, an outstanding performer receives a 4.4 percent increase, an average performer a 2.8 percent increase, and a poor performer a 0.4 percent increase.[47] Finally, companies increasingly use merit bonuses. As with merit increases, *merit bonuses* are based on a performance rating but, unlike merit increases, are paid in the form of a lump sum rather than becoming (a permanent) part of the base salary.[48] Merit bonuses may now be more important than traditional merit increases. "Indeed, merit bonuses now appear to account for more of the pay-performance relationship than do the traditional and most often discussed form of pay for individual performance, merit pay."[49] In companies that use merit bonuses and among those workers who receive them, the average annual merit bonus in recent years has been about 5 percent for hourly employees, 6 percent for lower level salaried employees, and 13 percent for higher level (but below officers/executives) salaried employees, all much larger than the more often discussed recent merit increase pools of around 3 percent.[50] We return to this issue in Chapter 18.

Cash Compensation: Incentives

Incentives also tie pay increases to performance.[51] However, incentives differ from merit adjustments. First, incentives are tied to objective performance measures (e.g., sales) usually in a formula-based way, whereas a merit increase program typically relies on a subjective performance rating. There is also some subjectivity in the size of the pay increase awarded for a particular rating. Second, incentives do not increase the base wage and so must be re-earned each pay period. Third, the potential size of the incentive payment will generally be known (given the use of a formula) beforehand. Whereas merit pay programs evaluate past performance of an individual and then decide on the size of the increase, what must happen in order to receive the incentive payment is called out very specifically ahead of time. For example, a Toyota salesperson knows the **commission** on a Land Cruiser versus a Prius prior to making the sale. The larger commission he or she will earn by selling the Land Cruiser is the incentive to sell a customer that car rather than the Prius. Fourth, while both merit pay and incentives try to influence performance, incentives explicitly try to influence future behavior whereas merit recognizes (rewards) past behavior, which is hoped to influence future behavior. The incentive-reward distinction is a matter of timing.

Incentives can be tied to the performance of an individual employee, a team of employees, a total business unit, or some combination of individual, team, and unit.[52] The performance objective may be expense reduction, volume increases, customer satisfaction, revenue growth, return on investments, increase in stock value—the possibilities are endless. Prax Air, for example, used return on capital (ROC). For every quarter in which a 6 percent ROC target is met or exceeded, Prax Air awarded bonus days of pay. An 8.6 percent ROC means 2 extra days of pay for that quarter for every employee covered by the program. An ROC of 15 percent means 8.5 extra days of pay.

Because incentives are one-time payments, they do not permanently increase labor costs. When performance declines, incentive pay automatically declines, too. Consequently, incentives (and sometimes merit bonuses also) are frequently referred to as **variable pay.**

Incentives can have powerful effects, both good and bad, on performance. On average, these effects are positive and substantial. However, incentives are risky, and they can go wrong in spectacular fashion.[53] One example is the Great Financial Crisis, which apparently stemmed in large part from improper and aggressive incentives paid to encourage loan officers to give home loans (mortgages) to people who were unlikely to be able to pay them back. (Recent events at Wells Fargo provide further examples.) We will talk about more examples in later chapters.

Long-Term Incentives

Incentives may be short- or long-term. Long-term incentives are intended to focus employee efforts on multiyear results. Typically they are in the form of stock ownership or else options to buy stock at a fixed price (thus leading to a monetary gain to the degree the stock price later goes up). The belief underlying stock ownership is that employees with a financial stake in the organization will focus on long-term financial objectives: return on investment, market share, return on net assets, and the like. Bristol-Myers Squibb grants stock to selected “Key Contributors” who make outstanding contributions to the firm’s success. Stock options are often the largest component in an executive pay package. Some companies extend stock ownership beyond the ranks of managers and professionals. Intel, Google, and Starbucks, for example, offer stock and/or stock options to all their employees.[54]

Benefits: Income Protection

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

Medical insurance, retirement programs, life insurance, and savings plans are common benefits. They help protect employees from the financial risks inherent in daily life. Often companies can provide these protections to employees more cheaply than employees can obtain them for themselves. In the United States, employers spend roughly $657 billion per year on health care costs, or 20 percent of all U.S. health care expenditures. Among employers that provide health insurance, the cost to provide family coverage is $18,764 per year per employee. The average employer pays $13,050 (70 percent) of that and the average employee pays the remaining $5,714 (30 percent).[55] Given the magnitude of such costs, it is no surprise that employers have sought to rein in or reduce benefits costs. One approach has been to shift costs to employees (e.g., having employees pay a larger share of health insurance premiums).[56] Some companies have allowed their benefits costs to get so far out of control that more drastic action has been taken. For example, as noted, companies like Chrysler, GM, and American Airlines have recently gone through bankruptcy, which has been used to reduce benefits costs and labor costs more generally. GM benefits costs had gotten so high that GM was sometimes described as a pension and health care provider that also makes cars.

Benefits: Work/Life Balance

Programs that help employees better integrate their work and life responsibilities include time away from work (vacations, jury duty), access to services to meet specific needs (drug counseling, financial planning, referrals for child and elder care), and flexible work arrangements (telecommuting, nontraditional schedules, nonpaid time off). Responding to the changing demographics of the workforce (two-income families or single parents who need work-schedule flexibility to meet their family obligations), many U.S. employers are giving a higher priority to these benefit forms. Medtronic, for example, touts its Total Well-Being Program that seeks to provide "resources for growth—mind, body, heart, and spirit" for each employee. Health and wellness, financial rewards and security, individual and family well-being, and a fulfilling work environment are part of this "total well-being."[57] Medtronic believes that this program permits employees to be "fully present" at work and less distracted by conflicts between their work and nonwork responsibilities.

Benefits: Allowances

Allowances often grow out of whatever is in short supply. In Vietnam and China, housing (dormitories and apartments) and transportation allowances are frequently part of the pay package. Many decades after the end of World War II–induced food shortages, some Japanese companies still continue to offer a "rice allowance" based on the number of an employee's dependents. Almost all foreign companies in China discover that housing, transportation, and other allowances are expected.[58] Companies that resist these allowances must come up with other ways to attract and retain employees. In many European countries, managers assume that a car will be provided—only the make and model are negotiable.[59]

Total Earnings Opportunities: Present Value of a Stream of Earnings

Up to this point we have treated compensation as something received at a moment in time. But a firm's compensation decisions have a temporal effect. Say you have a job offer at $50,000 a year. If you stay with the firm for five years and receive an annual increase of 4 percent, in five years you will be earning $60,833 a year. For your employer, the five-year cost commitment of the decision to hire you turns out to be $331,649 in cash. If you add in an additional 30 percent for benefits, the decision to hire you implies a commitment of over $430,000 from your employer. Will you be worth it? You will be, after this course.

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

Relational Returns from Work

Why do Google millionaires continue to show up for work every morning? Why does Andy Borowitz write the funniest satirical news site on the web (www.borowitzreport.com) for free? There is no doubt that nonfinancial returns from work have a substantial effect on employees' behavior.[60] Exhibit 1.4 includes such relational returns from work as recognition and status, employment security, challenging work, and opportunities to learn. Other forms of relational return might include personal satisfaction from successfully facing new challenges, teaming with great co-workers, receiving new uniforms, and the like.[61] Such factors are part of the total return, which is a broader umbrella than total compensation.

The Organization as a Network of Returns

Sometimes it is useful to think of an organization as a network of returns created by all these different forms of pay, including total compensation and relational returns. The challenge is to design this network so that it helps the organization to succeed.[62] As in the case of crew rowers pulling on their oars, success is more likely if all are pulling in unison rather than working against one another. In the same way, the network of returns is more likely to be useful if bonuses, development opportunities, and promotions all work together.

So the next time you walk through an employer's door, look beyond the cash and health care offered to search for all the returns that create the network. Even though this book focuses on compensation, let's not forget that compensation is only one of many factors affecting people's decisions about work. (You might enjoy listening to Roger Miller's song "Kansas City Star," or Chely Wright's "It's the Song" for some other reasons people choose their work.)

A PAY MODEL

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

Compensation Objectives

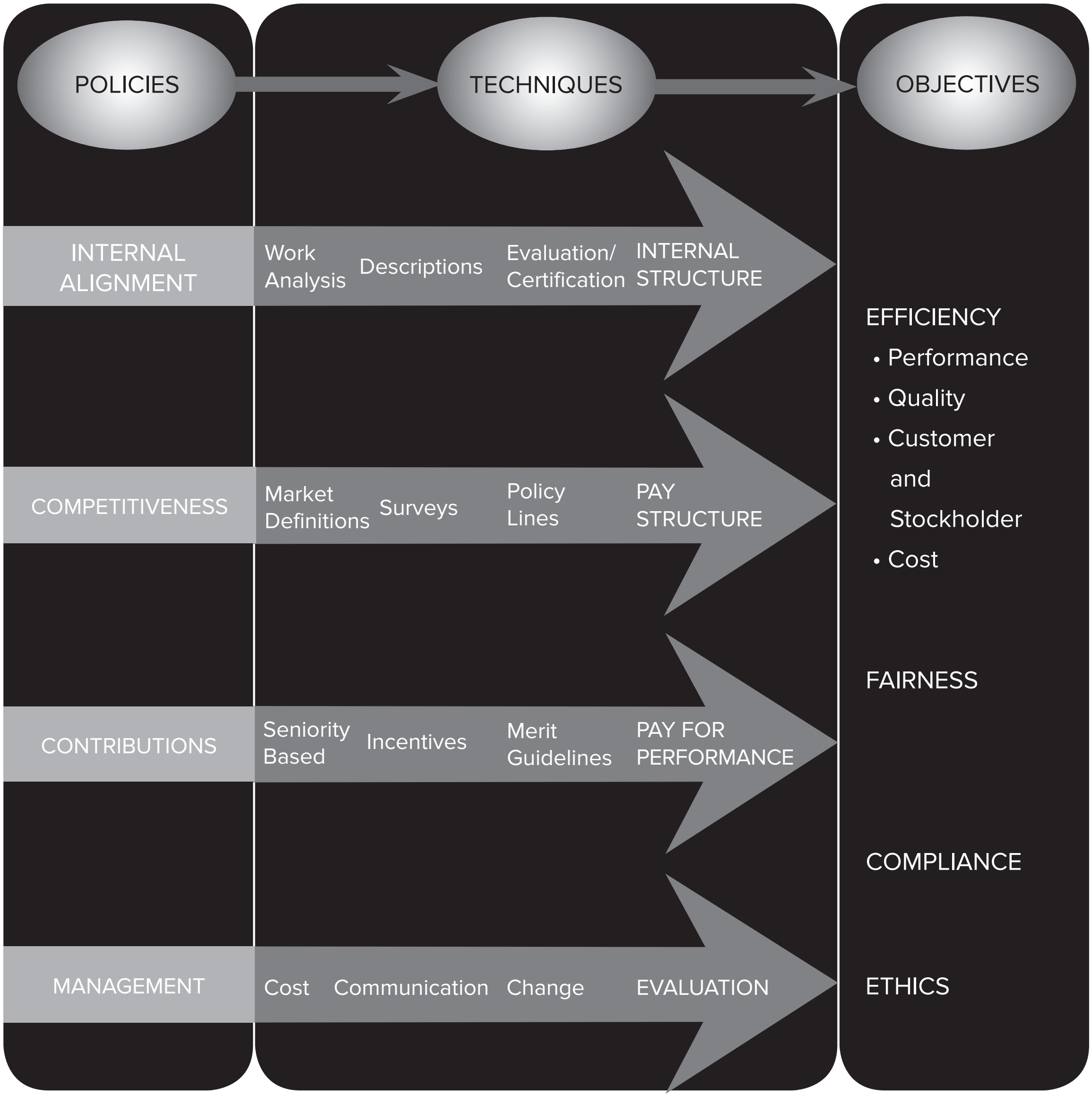
Pay systems are designed to achieve certain objectives. The basic objectives, shown at the right side of the model, include efficiency, fairness, ethics, and compliance with laws and regulations. *Efficiency* can be stated more specifically: (1) improving performance, increasing quality, delighting customers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

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

Whole Foods is the nation's largest organic- and natural-foods grocer. Its markets are a "celebration of food": bright, well stocked, and well staffed.[63] The company describes its commitment to offering the highest quality and least processed foods as a shared responsibility. Its first compensation objective is "Increase long-term shareholder value."

Fairness (sometimes called equity) is a fundamental objective of pay systems.[64] In Medtronic's objectives, fairness means to "ensure fair treatment" and "recognize

EXHIBIT 1.5 **The Pay Model**



personal and family well-being." Whole Foods's pay objectives discuss a "shared fate." In their egalitarian work culture, pay beyond base wages is linked to team performance, and employees have some say about who is on their team.

The fairness objective calls for fair treatment for all employees by recognizing both employee contributions (e.g., higher pay for greater performance, experience, or

EXHIBIT 1.6 Pay Objectives at Medtronic and Whole Foods

Medtronic	Whole Foods
Support Medtronic mission and increased complexity of business	Increase long-term shareholder value
Minimize increases in fixed costs	Earn profits daily through voluntary exchange with our customers
Attract and engage top talent	Through profits, create capital for growth, prosperity, opportunity, job satisfaction, and job security
Emphasize personal, team, and Medtronic performance	Support team member happiness and excellence
Recognize personal and family total well-being	Acknowledge that team outcomes are collective
Ensure fair treatment	

training) and employee needs (e.g., a fair wage as well as fair procedures). *Procedural fairness* refers to the process used to make pay decisions.[65] It suggests that the way a pay decision is made may be equally as important to employees as the results of the decision *(distributive fairness)*.

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

Ethics

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

Ethics means the organization cares about how its results are achieved.[66] Scan the websites or lobby walls of corporate headquarters and you will inevitably find statements of "Key Behaviors," "Our Values," and "Codes of Conduct." One company's code of conduct is shown in Exhibit 1.7. The challenge is to put these statements into daily practice. The company in the exhibit is the formerly admired, now reviled, Enron, whose employees lost not only their Enron jobs, but also the money they invested in Enron stock (in some cases, their entire retirement nest egg).

Because it is so important, it is inevitable that managing pay sometimes creates ethical dilemmas. Manipulating results to ensure executive bonus payouts, misusing (or failing to understand) statistics used to measure competitors' pay rates, repricing or backdating stock options to manipulate (increase) their value, encouraging employees to invest a portion of their wages in company stock while executives are bailing out, offering just enough pay to get a new hire in the door while ignoring the relationship to co-workers' pay, and shaving the hours recorded in employees' time card—these are all-too-common examples of ethical lapses.

Some, but not all, compensation professionals and consultants remain silent during ethical misconduct and outright malfeasance. Absent a professional code, compensation managers must look to their own ethics—and the pay model, which calls

EXHIBIT 1.7 Enron's Ethics Statement

Foreword

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

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

Values

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

Source: *Enron's Code of Ethics*, The Smoking Gun, July 2000.

for combining the objectives of efficiency and fair treatment of employees as well as compliance.[67]

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

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

In summary, objectives guide the design of pay systems. They also serve as the standards for judging the success of the pay system. If the objective is to attract and retain the best and the brightest skilled employees, but they are leaving for higher-paying jobs elsewhere, the system may not be performing effectively. Although there may be many nonpay reasons for such turnover, objectives provide standards for evaluating the effectiveness of a pay system.[68]

Four Policy Choices

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

Internal Alignment

Internal alignment refers to comparisons among jobs or skill levels inside a single organization. Jobs and people's skills are compared in terms of their relative contributions to the organization's business objectives. How, for example, does the work of the programmer compare with the work of the systems analyst, the software engineer, and the software architect? Does one contribute to solutions for customers and satisfied stockholders more than another? What about two marketing managers working in different business units of the same organization? Internal alignment pertains to the pay rates both for employees doing equal work and for those doing dissimilar work. In fact, determining what is an appropriate difference in pay for people performing different work is one of the key challenges facing managers. Whole Foods tries to manage differences with a salary cap that limits the **total cash** compensation (wages plus bonuses) of any executive to 19 times the average cash compensation of all full-time employees. The cap originally started at eight times the average. However, attraction and retention problems were cited as a need for raising the cap several times since. (Note that the cap does not include stock options.)

Pay relationships within the organization affect all three compensation objectives. They affect employee decisions to stay with the organization, to become more flexible by investing in additional training, or to seek greater responsibility. By motivating employees to choose increased training and greater responsibility in dealing with customers, internal pay relationships indirectly affect the capabilities of the workforce and hence the efficiency of the entire organization. Fairness is affected through employees' comparisons of their pay to the pay of others in the organization. Compliance is affected by the basis used to make internal comparisons. Paying on the basis of race, gender, age, or national origin is illegal in the United States.

External Competitiveness

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

Many organizations claim their pay systems are market-driven—that is, based almost exclusively on what competitors pay. "Market-driven" gets translated into practice in different ways.[69] Some employers may set their pay levels higher than their competition, hoping to attract the best applicants. Of course, this assumes that someone is able to identify and hire the "best" from the pool of applicants. And what is the appropriate market? When, for example, should international pay rates be considered? Should the pay of software engineers in New Delhi or Minsk influence pay for engineers in Silicon Valley or Boston?

External competitiveness decisions—both how much and what forms—have a twofold effect on objectives: (1) to ensure that the pay is sufficient to attract and retain employees—if employees do not perceive their pay as competitive in comparison to what other organizations are offering for similar work, they may be more likely to leave—and (2) to control labor costs so that the organization's prices of products or services can remain competitive in a global economy.

Employee Contributions

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

The emphasis to place on **employee contributions** (or nature of **pay mix**) is an important policy decision because it directly affects employees' attitudes and work behaviors. Eaton and Motorola use pay to support other "high-performance" practices in their workplaces.[70] Both use team-based pay and corporate profit-sharing plans. Starbucks emphasizes stock options and sharing the success of corporate performance with the employees. General Electric uses different performance-based pay programs at the individual, division, and company-wide levels. Performance-based pay affects fairness, in that employees need to understand the basis for judging performance in order to believe that their pay is fair.

What mix of pay forms—base, incentives, stock, benefits—do our competitors use in comparison to the pay mix we use? Whole Foods combines base pay and **team incentives** to offer higher pay if warranted by team performance. Nucor targets base pay below market, but targets total cash compensation (including profit sharing and gain-sharing/plant production bonuses) at well above the market median. Medtronic sets its base pay to match its competitors but ties bonuses to performance. It offers stock to all its employees, based on overall company performance.[71] Further, Medtronic believes that its benefits, particularly its emphasis on programs that balance work and life, make it a highly attractive place to work. It believes that *how* its pay is positioned and *what forms* it uses create an advantage over competitors.

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

Management

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

Managing compensation means answering the "So What?" question. So what is the impact of this policy, this technique, this decision? Although it is possible to design a system that is based on internal alignment, external competitiveness, and employee contributions, what difference does it make? Does the decision help the organization achieve its objectives?[72]

The ground under compensation management has shifted. The traditional focus on how to administer various techniques is long gone, replaced by more strategic thinking—managing pay as part of the business. It goes beyond simply managing pay as an expense to better understanding and analyzing the impact of pay decisions on people's behaviors and organizations' success. The impact of pay decisions on expenses is one result that is easily measured and well understood. But other measures—such as pay's impact on attracting and retaining the right people, and engaging these people productively—are not yet widely used in the management of compensation. Efforts to do so are increasing, and the perspective is shifting from "How to" toward trying to answer the "So What?" question.[73] Ease of measurement is not the same as importance; costs are easy to measure (and, of course, important), so there is a tendency to focus there. Yet the consequences of pay, although often less amenable to measurement, are nonetheless just as important.

Pay Techniques

The remaining portion of the pay model in Exhibit 1.5 shows the techniques that make up the pay system. The exhibit provides only an overview since techniques are discussed throughout the rest of the book. Techniques tie the four basic policies to the pay objectives.

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

e-Compensation

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

BOOK PLAN

Compensation is such a broad and compelling topic that there are several books devoted to it. This book focuses on the design and management of compensation systems. To aid in understanding how and why pay systems work, our pay model provides the structure for much of the book. Chapter 2 discusses how to formulate and execute a compensation strategy. We analyze what it means to be strategic about how people are paid and how compensation can help achieve and sustain an organization's competitive advantage.[74]

The pay model plays a central role in formulating and implementing an organization's pay strategy. The model identifies four basic policy choices that are the core of the pay strategy. After we discuss strategy, the next sections of the book examine each of these policies in detail. Part 2 on *internal alignment* (Chapters 3, 4, 5, and 6) examines pay relationships within a single organization. Part 3 (Chapters 7 and 8) examines *external competitiveness*—the pay relationships among competing organizations—and analyzes the influence of market-driven forces.

Once the compensation rates and structures are established, other issues emerge. How much should we pay each individual employee? How much and how often should a person's pay be increased, and on what basis—experience, seniority, or performance? Should pay increases be contingent on the organization's and/or the employee's performance? How should the organization share its success (or failure) with employees? These are questions of *employee contributions,* the third building block in the model, covered in Part 4 (Chapters 9, 10, and 11).

In Part 5, we cover employee services and benefits (Chapters 12 and 13). How do benefits fit in the company's overall compensation package? What choices should employees have in their benefits? In Part 6, we cover systems tailored for special groups—sales representatives, executives, contract workers, unions (Chapters 14 and 15)—and we provide more detail on global compensation systems (Chapter 16). Part 7 concludes with information essential for *managing the compensation system*. The government's role in compensation is examined in Chapter 17. Chapter 18 includes understanding, communicating, budgeting, and evaluating results.

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

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

CAVEAT EMPTOR—BE AN INFORMED CONSUMER

Most managers do not read research. They do not subscribe to research journals; they find them too full of jargon and esoterica, and they see them as impractical and irrelevant.[75] However, a study of 5,000 HR managers compared their beliefs to the research evidence in several areas and identified seven common and important misconceptions held by managers.[76] The study authors concluded that being unaware of key research findings may prove costly to organizations. For example, when it comes to motivating workers, organization efforts may be somewhat misguided if they do not know that "money is the crucial incentive . . . no other incentive or motivational technique comes even close to money with respect to its instrumental value."[77]

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

1. Is the Research Useful?

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

2. Does the Study Separate Correlation from Causation?

Once we are confident that the variables are useful and accurately measured, we must be sure that they are actually related. Most often this is addressed through the use of statistical analysis. The **correlation coefficient** is a common measure of association and indicates how changes in one variable are related to changes in another. Many research studies use a statistical analysis known as *regression analysis*. One output from a regression analysis is the R^2. The R^2 is a squared correlation and tells us what percentage of the variation in the outcome variable is accounted for by the variables we are using to predict or explain.

But even if there is a relationship, correlation does not ensure causation. For example, just because a manufacturing plant initiates a new incentive plan and the facility's performance improves, we cannot conclude that the incentive plan caused the improved performance. Perhaps new technology, **reengineering,** improved marketing, or the general expansion of the local economy underlies the results. The two changes are associated or related, but causation is a tough link to make.

Too often, case studies, benchmarking studies of best practices, or consultant surveys are presented as studies that reveal cause and effect. They do not. Case studies are descriptive accounts whose value and limitations must be recognized. Just because the best-performing companies are using a practice does not mean the practice is causing the performance. IBM provides an example of the difficulty of deciding whether a change is a cause or an effect. Years ago, IBM pursued a no-layoff policy. While IBM was doing well, the no-layoff policy was cited as part of the reason. Later, when performance declined, IBM eventually ended the no-layoff policy as a partial response. Did the policy contribute to company success at one time, but not later due to changing circumstances? Did it always act as a drag on company success? Or was it a mistake to get rid of it? Causality is difficult to infer as we do not know what would have happened had IBM never had the policy and/or if they had it and kept it (versus ending it). Perhaps because of such challenges in inference, compensation research often does attempt to answer questions of causality. Yet good policy decisions rest on making good causal inferences.[78] Thus, we need to strive to overcome the challenges to answer key questions such as: How does the use of performance-based pay influence employee ability and motivation, customer satisfaction, product quality, and company performance?

3. Are There Alternative Explanations?

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

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

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

So we encourage you to become a critical reader of all management literature, including this book. As Hogwarts' famous Professor Alastor Moody cautions, have "constant vigilance for sloppy analysis masquerading as research."[79]

Your **Turn**

The Role of Labor Costs in Retail Electronics

Let's get started with trying to assess the degree to which compensation is an important cause of company success (or lack of success) in two different competitive environments.

First, let's consider the case of consumer electronics and the experiences of Circuit City and Best Buy. Circuit City had traditionally used a commission pay plan that paid off big for experienced, high-performing salespeople. Top salespeople knew the products and kept up to date, and customers knew that they could get expert advice at Circuit City. The strategy differentiated Circuit City from archrival Best Buy, which featured self-service stores with huge inventories but less-expert salespeople. Best Buy hired young, less-experienced people and offered lower wages and smaller bonuses. However, Best Buy's sales and total shareholder returns soared past those of Circuit City. Subsequently, Circuit City laid off 3,900 top-earning salespeople in 2003 and replaced them with 2,100 less-experienced people who received lower wages and smaller bonuses. Circuit City said it could no longer afford to pay big commissions to its sales staff while its rivals paid less.[80]

In 2007 Circuit City fired 3,400 of its highest-paid store employees and again began to replace them with lower-paid workers in hopes of reducing labor costs. In the following quarter, Circuit City reported that the company lost money. Some commentators attributed the loss to the fact that Circuit City had gotten rid of many of its most experienced and highly trained employees, which they believed translated into a poorer customer experience and, in turn, lower revenues and profits.

For example, according to *BusinessWeek*, "In the world of pricey consumer electronics, where customer service is arguably as important as quality products, Circuit City Stores is missing the mark and further eroding its profits." However, a company spokesman said that only a few salespeople per store were affected by the workforce reductions and that many of the employees affected worked as customer service representatives or in the warehouses. He questioned whether the cuts had significantly affected the in-store customer experience and thus whether the cuts had caused the decline in the company's performance. Eventually the bottom fell out of Circuit City's profits and stock price and it had to liquidate, closing its 500-plus stores (resulting in over 30,000 employees losing their jobs).[81]

Now consider the next part of the story. Best Buy itself subsequently sought to further cut its own labor costs by essentially demoting 8,000 senior sales associates to positions that could pay half as much. A question was whether the Best Buy pay-level cuts would have the same consequences as what one person described as the "disastrous personnel moves" made at Circuit City just a few years ago.[82] Apparently Best Buy did not see it that way. Subsequently, in 2012, Best Buy announced that it would close 50 stores and also cut 400 corporate jobs in an effort to cut $800 million in costs. Why is Best Buy aggressively cutting costs? *USA Today* stated that Best Buy "is trying to avoid the fate of Circuit City, which went out of business in 2009." (See also Radio Shack.) It faces slower sales of expensive items like TVs, plus increased competition from Amazon.com and discount stores such as Walmart and Target.[83] Employment at the headquarters has been an ongoing target and is now around 5,000 employees, down from its peak of 9,000 in the mid-2000s. After those cuts, store closings, and pay cuts, Best Buy next (in 2014) cut employment by around 2,000 in its stores and regional offices. However, the cuts are being made in a way that Best Buy hopes will minimize any negative impact on the customer experience. Most of the cuts target middle managers, many of whom have six-figure salaries and who supervise product categories at more than a dozen stores each. That will leave fewer middle managers (spread more thinly across more stores) and give more responsibility to the store managers, who will now have the "full ability to run their (respective) stores." The cuts, which target regional offices rather than stores and employees who directly help shoppers, are intended to minimize the impact on customer service inside stores, while helping Best Buy continue to lower costs as it continues to successfully compete on price (and service) against Amazon, Walmart, Target, and others with low cost structures.

Here are data on stock prices and customer satisfaction for Circuit City, Best Buy, and two other competitors, Amazon and Walmart.

	Opening Stock Price				Customer Satisfaction (ASCI Index)			
Year	Circuit City	Best Buy	Amazon	Walmart	Circuit City	Best Buy	Amazon	Walmart
2000	48	26	82	68			84	73
2001	16	18	16	53		84	75	
2002	29	32	11	58		88	74	
2003	7	18	19	51	73	72	88	75
2004	9	36	53	53	73	72	84	73
2005	14	37	45	54	72	72	87	72
2006	23	47	48	46	70	71	87	72
2007	19	50	37	47	69	76	88	68
2008	4	44	96	47	71	74	86	70
2009	0	28	51	56	72	74	86	71
2010	*	40	136	53	*	77	87	73
2011	*	34	181	54	*	77	86	70
2012	*	24	176	60	*	78	85	71
2013	*	12	257	69	*	77	88	71
2014	*	41	398	79	*	77	86	68
2015	*	39	309	86	*	74	83	66
2016	*	30	656	61	*	77	86	72
2017	*	43	758	69	*	78	85	71
2018	*	69	1172	99				
2019	*	54	1539	93				

Source: The American Customer Satisfaction Index.

Note: No more recent data available for ASCI.

ASCI = American Customer Satisfaction Index™, http://www.theacsi.org/. ASCI scores for Circuit City and Best Buy not available prior to 2003.

*Circuit City no longer in business.

QUESTIONS:

1. Thinking back to our discussion in the section *Caveat Emptor*—Be An Informed Consumer, evaluate whether the replacement of highly paid workers with lower-paid workers did or did not cause Circuit City to perform so poorly. How confident are you in your evaluation? Why?
2. How is Best Buy doing? Did its cuts to labor costs work?
3. Why are Walmart and Amazon doing better than Best Buy (and Circuit City)? Do they have higher pay?
4. Are there larger problems in the competitive landscape for Best Buy that cannot be solved by compensation strategy changes (e.g., labor cost reductions) alone? When customers look to buy electronics, what options do they have other than Best Buy, and why would they choose these options over Best Buy? Where do customers "test drive" the product and where do they buy it? Can compensation changes address these challenges? Explain.
5. Is Best Buy focusing too much or too little on cost reduction? Explain.
6. If you had answered these questions about Best Buy in 2013 (when its stock price was at 13), what would you have expected to happen to Best Buy? Are you surprised by their performance since 2013? What lesson, if any, do you take away from their reversal of fortune?

Summary

The model presented in this chapter provides a structure for understanding compensation systems. The three main components of the model are the compensation objectives, the policy decisions that guide how the objectives are going to be achieved, and the techniques that make up the pay system and link the policies to the objectives. The following sections of the book examine each of the four policy decisions—internal alignment, external competitiveness, employee performance, and management—as well as the techniques, new directions, and related research.

Two questions should constantly be in the minds of managers and readers of this text. First: Why do it this way? There is rarely one correct way to design a system or pay an individual. Organizations, people, and circumstances are too varied. But a well-trained manager can select or design a suitable approach. Second: So what? What does this technique do for us? How does it help achieve our goals? If good answers to the "So What?" question are not apparent, there is no point to the technique. Adapting the pay system to meet the needs of the employees and helping to achieve the goals of the organization is what this book is all about.

The basic premise of this book is that compensation systems do have a profound impact. Yet, too often traditional pay systems seem to have been designed in response to some historical but long-forgotten problem. The practices continue, but the logic underlying them is not always clear or even relevant. Hopefully, the next generation of pay systems will be more flexible—designed to achieve specific objectives under changing conditions.

Review Questions

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

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