# CHAPTER ONE

# THE PAY MODEL

#### **Overview**

Part One, Introducing the Pay Model and Pay Strategy, contains chapters one and two and begins by talking about what “pay” means and how paying people in different ways can influence them and, in turn, organization success. The two chapters describe the compensation policies and techniques that organizations use and the multiple objectives they hope to achieve by effectively managing these compensation decisions. The aim of Part One is to understand how compensation strategy decisions interact with the specific context of an organization (its business and human resource strategies) to influence organization success. The authors emphasize that good theory and research are fundamental to not only understanding compensation’s likely effects, but also to developing that healthy skepticism needed toward simplistic claims about what works and what does not.

Chapter one starts with a discussion on the role of poorly designed compensation plans in the current economic situation. It provides an overview of the key components of a compensation system. The definition of compensation is initially explored from the perspectives of the society, stockholders, the organization, and the external environment. Next, the various forms of pay are identified and defined. The major focus is presenting a *pay model* that provides a structure for understanding compensation systems. The three main components of the model are (1) compensation objectives, including the importance given to ethics; (2) policy decisions that guide the way objectives will be achieved; and (3) techniques that make up the pay system. The book plan is outlined at the end of chapter one. The remaining chapters 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.

## Learning Objectives

* Compare the benefits of well-designed compensation systems to the detriments of poorly designed compensation systems.
* Define compensation from the perspectives of society, stockholders, the organization, and the external environment.
* Examine the various forms of pay including cash compensation, benefits, total earnings opportunities, and relational returns from work.
* Understand the three components of the pay model: compensation objectives, policy choices, and pay techniques.

## Lecture Outline: Overview of Major Topics

## I. Compensation: Does it Matter (or, “So What?”)

## II. Compensation: Definition, Please (Stakeholders)

### A. Society

B. Stockholders

C. Customers

D. Managers

E. Employees

III. How Pay Influences Behaviors: Incentives and Sorting Effects

A. Global Views – Vive la Différence

## IV. Forms of Pay

A. Cash Compensation: Base

B. Cash Compensation: Merit Increases/Short-Term Incentives (Merit Bonuses)/COLAs

C. Cash Compensation: Incentives

D. Long-Term Incentives

E. Benefits: Income Protection

F. Benefits: Work/Life Balance

G. Benefits: Allowances

H. Total Earnings Opportunities: Present Value of a Stream of Earnings

I. Relational Returns from Work

## V. A Pay Model

A. Compensation Objectives

B. Four Policy Choices

C. Pay Techniques

## VI. Book Plan

## VII. *Caveat Emptor*—Be an Informed Consumer

A. Is the Research Useful?

B. Does the Study Separate Correlation from Causation?

C. Are There Alternative Explanations?

## VIII. Your Turn: Compensation at the World’s Largest Company

IX. Still Your Turn: Who are Amazon’s Peer Companies for Comparing Compensation?

X. Summary

XI. Review Questions

Lecture Outline: Summary of Key Chapter Points

1. **Compensation: Does It Matter? (Or, “So What?”)**
	* 1. The role of poorly designed compensation plans is analyzed from different perspectives.
			+ Companies that failed in recent times had labor costs higher than competition without the corresponding advantages in efficiency, quality, and customer service.
				- Examples in the text include Chrysler and General Motors (GM).

Chrysler was paying $76/hour in pay and benefits

Vs. Toyota paying $48/hour in pay and benefits (in the U.S.)

Vs. average total compensation for all U.S. manufacturing was $25/hour – and $3/hour in Mexico

Chrysler was not sustainable and filed for bankruptcy

they were bought out by Fiat

brought pay costs down to $49/hour

and are now part of Stellantis

GM also filed bankruptcy in 2009

Their problems included more than overcompensating their employees

As of 2021, GM’s market value was over $80 billion

Far behind Tesla, at $635 billion

* + - * Successful companies had relatively high pay as well as higher productivity compared to competitors.
				+ One example in the text is Nucor Steel who had higher productivity than is typical in the steel industry

Both the company and its workers do well

* + - * + Apple reduced prices for iPads and iPhones by outsourcing manufacturing to China

In facilities owned by a Taiwanese company

This generated billions in cost savings per year

* + - * + Google and Facebook are known for paying very well

High pay allows them to be selective in hiring and retention

This helps them 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 themselves and their firms a lot of money.
				+ When the markets discovered that many such risks had gone bad, the firms either had to file for bankruptcy or wait for other companies to take them over.
				+ An important driver of risk taking is the incentive system that encourages them to be “confident and aggressive.”
			* The U.S. Justice Department announced a $678 million settlement with Novartis over improper inducements to persuade doctors to prescribe Novartis drugs
				+ This was the largest whistleblower settlement under federal law
				+ The whistleblower wore a wire for the feds to change the way the pharmaceutical industry operated
				+ Novartis then changed its sales compensation so pay no longer depends only on sales
				+ Pay also now depends on if sales were achieved in a way consistent with their code of ethics
		1. How people are paid affects their behavior at work, which affects an organization’s success.
			- For most employers, compensation is a major part of total cost, and often it is the single largest part of operating costs.
			- Well-designed compensation systems can help an organization achieve and sustain competitive advantage.
			- Poorly designed compensation systems can play a major role in undermining organization success.
1. **Compensation: Definition, Please (Stakeholders)**
	* 1. People’s view of compensation differs depending on whether they look at compensation from the perspective of a member of society, a stockholder, a manager, or an employee.
		2. Thus, the text analyzes the definition and importance of compensation from several different perspectives.
	1. **Society**
		1. Exhibit 1.1 summarizes information on indicators of economic standard of living
			* At the top, Panel A, economic output (GDP) per Employed Person, is a measure of national productivity
				+ Productivity increased by 52% since 1990

In general, increases in productivity are necessary to generate increases in income and wealth for the population

Note that the productivity in the U.S. in 2020 ($127,378I) is the highest among the 30 largest world economies

* + - * Panel B shows the average annual earnings increased 23% since 1990
			* Panel C moves from individual earnings to household income – with two sets of household income, before and after taxes transfers
				+ Overall income grew by 45% since 1990, before taxes and transfers and 51% after adjusting for taxes and transfers
				+ The way income and wealth is distributed is also important

Income shares for the top 1% in 2020, after transfers and taxes, was $1,343,000 and it has grown by 110% since 1990

In contrast, the other quintiles income is considerably lower in 2020 ($68,000 in the middle quintile)

Although their growth rates are positive and significant, ranging from 37% to 68%

Their growth has been considerably lower than for the top 1% group

* + - * Finally, Panel D shows household wealth and individual wealth
				+ Household wealth has grown substantially over time, nearly tripling from 1990 to 2020
				+ However, the population also grew, but at a much smaller rate
				+ Wealth is very concentrated

The top 10% hold 77% of the country’s wealth

The top 1% hold 38% of its wealth

* + - * + The concentration of wealth has increased since 1990
		1. Some people see pay as a measure of justice.
			- For example: comparing earnings of women with those of men highlights potential pay inequities.
				* Among full-time U.S. workers, women earn 82% of what men earn
				* If women have the same characteristics as men, especially years and continuity of work, and worked in the same occupations and industries

The gap narrows by one-half or more

They may earn 93% of what comparable men earn, but this is still a sizable gap

* + - * Society has taken an interest in such earnings differentials – exhibited by laws and regulations aimed at eliminated the discrimination that causes them
		1. It seems clear that people care greatly about their income, but does it matter up to a point?
			- Based on one well-known study, $95,000 has been identified as the magic amount of annual income that makes people happy.
			- Paying them more had severely diminishing returns and more pay did not increase their happiness any further.
				* However, that result is based on asking people about their emotion well-being (happiness) they experienced yesterday.
				* Not feeling well, or having no social time yesterday made them less happy than pay.
			- In contrast, when asked about life evaluation on a scale ranging from 0 (worst) to 10 (best), there was almost no diminishing return to higher income.
				* There *was* a fairly steady rise in life evaluation in proportion to increases in income.
			- The findings can be interpreted to mean:
				* First, that increases in income that allow people to avoid poverty has a major positive impact on both happiness and life evaluation.
				* Second, that increases in income have diminishing returns for increasing happiness (emotional well-being).
				* Third, it would be a mistake to think that reducing anyone’s pay to $95,000 would do anything but make them unhappy.
				* Fourth, higher pay is associated with higher life satisfaction and that association continues beyond $95,000.
		2. Benefits given as a part of total compensation may also be seen as a reflection of societal equity or justice.
			- Private sector employers spend about 42 cents for benefits on top of every dollar paid for **wages** and **salaries**.
				* For state and local government employers, it is even higher at 62 cents.
			- Individuals and businesses in the U.S. spend $3.6 trillion per year on health care
				* Yet, over 30 million have no health insurance

A major reason is that most people under the age of 65 and not below the poverty line get health insurance through their employers

But small employers are less likely to offer health insurance

As a result, the great majority of uninsured are from working families

* + - * + Whenever the unemployment rate increases, health care coverage declines further
		1. Job losses or gains in a country over time are partly a function of relative labor costs (and productivity) across countries.
			- Exhibit 1.2 reveals that annual salary cost per employee (not including benefits) in Mexico is $17,594.
				* About a quarter of the $65,836 average salary in the U.S.
				* China’s estimated annual salary of $12,430 is less than one-fifth of the U.S. rate
			- However, the value of what is produced also needs to be considered.
				* Productivity in China is roughly one-fifth that of U.S. workers
				* Mexican worker productivity is about one-third of the U.S. level.
			- If low wages are the goal, there always seems to be somewhere that pays less.
				* The new goal may be to diversify production and supply chains to be less dependent on any one country
		2. Some consumers know that pay increases often lead to price increases.
			- They do not believe that higher labor costs benefit them.
			- Other consumers lobby for higher wages.
	1. **Stockholders**
		1. Stockholders differ on their views of whether employees should be given stock options or not.
			+ Supporters of this thought believe that it creates a sense of ownership that will improve performance and eventually increase stockholder wealth.
			+ Opponents argue that granting employees too much ownership dilutes stockholder wealth.
		2. Stockholders (also called shareholders) have a particular interest in executive pay.
			+ To the degree that the interests of executives are aligned with those of shareholders
				- e.g., by paying executives on the basis of company performance measures such as shareholder return,
				- The hope is that company performance will be higher.
			+ In the absence of a linkage between executive pay and company performance,
				- Concerns arise that the executives can somehow use their influence to obtain high pay without necessarily performing well.
			+ Exhibit 1.3 provides data on CEO compensation.
				- Note the large total annual compensation of $12.3 million
				- And that the bulk of compensation is connected to shareholder return or short-term performance measures.
				- As such, do not expect changes in CEO wealth and shareholder wealth to be aligned.

More on this topic in Chapter 14.

There, we suggest that, on average, CEO interests and shareholder interests are aligned

But there are important exceptions and an ongoing challenge to ensure executives act in the best interest of shareholders.

Top executives at Bear Stearns and Lehman Brothers exercised stock options and sold stock prior to the company’s meltdowns

So, while the long-term shareholders in their firms were largely decimated, due to the actions of executives

The executives, in contrast, did quite well

* + 1. Shareholders can influence executive compensation decisions through shareholder proposals and election of directors in proxy votes.
			- In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act on 2010 has a provision of “say on pay,”
			- Requiring public companies to submit their executive compensation plan to a nonbinding vote by shareholders.
			- Clawback provisions are available under Dodd-Frank and have also been adopted in stronger form by some companies.
	1. **Customers**
		1. Compensation is often the largest single operating cost of an organization.
			+ For companies whose business strategy depends on low product/service cost to compete for customers:
				- They also may focus on keeping compensation costs low.
				- This is true of Wal-Mart.
			+ Costco’s business strategy is less exclusively cost-based and depends on paying higher wages to attract and retain employees who can provide a higher level customer experience.
		2. Compensation also comes into play for customers who want to purchase from a company that acts with responsibility with respect to environmental, social, and governance (ESG) issues.
			+ Customers may base their buying decisions on:
				- How they believe the company treats their employees.
				- And/or how workers employed by other companies, but part of the supply chain, are treated.
			+ Apple has supplier responsibility standards and a system to monitor supplier adherence, including in the area of employment.
	2. **Managers**
		1. Managers view compensation as influencing their success in two ways.
			+ First, compensation is a major expense that needs managing.
			+ Second, it is a major determinate of employee attitudes and behaviors
		2. First, the cost issue.
			+ Competitive pressures force managers to consider the affordability of compensation decisions.
				- Since labor costs can account for more than 50% of total costs.
				- Some industries are even higher.
			+ However, labor costs as a percent of total costs vary among individual firms.
				- The neighborhood grocery, with labor costs between 15-18%, have been run out of business by supermarkets with lower labor costs of 9-12%.
				- Warehouse club stores enjoy even lower cost of labor at 4-6%.
				- Now that Amazon has entered grocery sales it will cause further cost reductions and disruption.
			+ Exhibit 1.4 compares the hourly pay rate for retail workers at Costco to that at Walmart and Sam’s Club.
				- Wages for the three jobs are higher at Costco.

This will increase further in 2021.

When its minimum wage goes to $16/hour.

* + - * + Walmart’s minimum wage remains at $11/hour.

In September of 2021, they increased this to $12/hour.

But Walmart discontinued quarterly bonuses.

* + - * Each retailer tries to provide a unique shopping experience.
				+ Both Walmart and Costco compete on price.
				+ Yet Costco appears to have chosen to pay higher wages as a way to attract and retain a higher quality workforce
				+ As Exhibit 1.4 shows, Costco is quite successful in terms of employee retention, customer satisfaction, and the efficiency with which it generates sales.
		1. Second, a manager can use pay to influence employee behaviors and to improve the organization’s performance.
			- High pay, if it brings high returns, is one strategy.
			- Pay affects quality of employee’s work, their attitude toward customers, and their willingness to be flexible, learn new skills, or suggest innovations.
			- Pay also may drive employees to unions or even legal action.
	1. **Employees**
		1. For most employees, pay is a major source of financial security.
			+ Employees may view 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 take/stay in a job and invest in performing well, or
				- as a reward for having done so.
			+ Compensation can be all of these things.
		2. The importance of pay is apparent in many ways.
			+ Wages and benefits are a major focus of labor unions’ efforts – Chapter 14.
			+ The legal framework governing pay
				- Minimum wage
				- Living wage
				- Overtime
				- Nondiscrimination regulations
			+ Points to the central importance of pay to employees in the employment relationship – Chapter 17.
		3. Next, we turn to how pay influences employee behaviors.
1. **How Pay Influences Behaviors: Incentive and Sorting Effects**
	* 1. Pay influences employee **motivation** and behavior in two ways:
			+ Pay can affect the motivational intensity, direction, and persistence of current employees.
			+ Motivation, together with employee **ability** and work/organizational design, determines employee behaviors such as performance.
				- This effect of pay is known as **incentive effect**.
				- The degree to which pay influences individual and aggregate motivation among the employees we have at any point in time.
		2. Pay can also have an indirect, but important, influence via a **sorting effect** on the composition of the workforce.
			+ That is, different types of pay strategies may cause different types of people to apply to and stay with an organization.
		3. It is not only how much, but *how* an organization pays that can result in a sorting effect.
			+ Would a highly capable individual with a strong work ethic and an interest in earning a lot of money prefer to work somewhere that pays everyone the same amount, regardless of performance?
			+ Or would they prefer to work in a place that pays higher for performance?
			+ People differ regarding which type of pay arrangement they prefer.
		4. The question for organizations is simply this: Are you using the pay policy that will attract and retain the types of employees you want?
			+ High performers have more job opportunities and may leave if they are not paid for their performance.
			+ This can be a problem if high performers are leaving.
			+ Especially if high performers create a disproportionately high amount of value for the organization.
				- This is the case if performance follows a *power law distribution*, rather than the normal distribution
		5. Turnover is not always in response to dissatisfaction.
			+ Turnover may result from employees receiving unsolicited outside offers.
			+ Sometimes, turnover is driven by opportunity.
		6. Let us look at one study regarding incentive and sorting effects.
			+ Individual worker productivity was measured before and after a company switched from a salary-only system to an individual incentive plan.
			+ An overall increase in productivity of 44% was observed.
				- Half of the increase was due to individuals being more productive.
				- The other half was from less-productive workers leaving as the system no longer favored them.
				- They were replaced by workers eager for the chance to make more money under a system that rewards performance.
			+ Focusing only on the incentive effects of pay can miss the other major mechanism (sorting) by which pay decisions influence employee behaviors.
		7. Another study looked at “stars” hired away from other firms and found they did generally less well in their new firms unless they moved with other members of their team, rather than alone.
			+ Star performance may be somewhat firm-specific.
			+ A firm cannot necessarily “buy talent” and expect the same level of performance.
			+ This may stem from the additional value created by being part of a well-functioning team.
		8. The pay model that comes later in this chapter includes compensation policies and the **objectives** (efficiency, fairness, compliance) these are meant to influence.
			+ Compensation policies work through employee incentive and sorting effects to either achieve or not achieve the company’s objectives.
	1. **Global Views—*Vive la Différence***
		1. In English, compensation means something that counterbalances, offsets, or makes up for something else.
		2. In China, the traditional characters for the word “compensation” are based on the symbols for logs and water; meaning that compensation provides the necessities in life.
			* In the recent past, compensation was viewed as an entitlement.
			* Today, a new word, *dai yu*, is used; it refers to how one is treated with respect to wages, benefits, training opportunities, and so on.
			* The contemporary meaning of compensation includes returns as well as entitlement.
		3. “Compensation” in Japanese is *kyuyo* which means “giving something.”
			* Traditionally, compensation was viewed as something given by one’s superior.
			* Today the word *hou-syu*, which means “reward,” is used; it has no association with notions of superiors.
			* *Teate*, which means “taking caring of something,” is regarded as compensation that takes care of employees’ financial needs.
			* It includes the many allowances (family, housing, and commuting allowances) still used in many Japanese companies.
		4. Contrasting ideas about compensation—multiple views and multiple meanings—add richness to the topic.
			* To minimize confusion, the following definition of “compensation” or “pay” is provided:
				+ **Compensation** refers to all forms of financial returns and tangible services and benefits employees receive as part of an employment relationship.
2. **Forms of Pay**
	* 1. Exhibit 1.5 shows the variety of returns people receive from work.
		2. Total returns are categorized as:
			+ **Total compensation**—these returns are transactional in nature and 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).
			+ **Relational returns**—these are psychological and include recognition and status, employment security, learning opportunities, challenging work and so on.
		3. So pay comes in different forms, and programs to pay people can be designed in a wide variety of ways.
			+ Both monetary rewards and intrinsic rewards are important to people.
			+ While this text focuses on monetary rewards which affects their attitudes, performance, and job choice, as well as their standard of living.
	1. **Cash Compensation: Base**
		1. *Base wage* is the cash compensation an employer pays for work performed.
			* It reflects value of work or skills and generally ignores differences attributable to individual employees.
			* Some pay systems set base wage as a function of the skill or education an employee possesses
		2. In the U.S., **salary** refers to pay given to employees who are **exempt** from regulations of the Fair Labor Standards Act and are exempt from overtime pay.
			* Managers and professionals usually fit this category.
				+ Pay is calculated at an annual or monthly rate rather than hourly.
			* *Nonexempts* have their pay calculated on an hourly wage.
			* Rather than dividing employees into separate categories, some organizations (IBM and Walmart) believe an “all-salaried” workforce reinforces an organizational **culture** where all employees are part of the same team.
				+ This does not negate the need to comply with the FLSA.
	2. **Cash Compensation: Merit Increases/Short-Term Incentives (Merit Bonuses)/COLAs**
		1. A *cost of living adjustment (COLA)* to base wages may be based on
			* Changes in what other employers are paying for the same work,
			* Changes in living costs,
			* Or changes in experience or skill.
		2. *Merit increases* are given as increments to the base pay and are based on performance.
			* In recent years, merit increase budgets have been around 3%.
			* Merit payments are based on an assessment of recent past performance.
			* On average, an outstanding performer receives a 4.8% increase, an average performer a 2.9% increase, and a poor performer a 0.2% increase.
		3. Companies increasingly use *merit bonuses*.
			* These are based on performance rating but are paid in the form of a lump sum rather than becoming (a permanent) part of the base salary.
			* Merit bonuses may now be more important than merit increases.
				+ In recent years merit bonuses have been about 6% for hourly employees, 7% for lower-level salaried employees, and 11% for higher level salaried employees.
				+ All much larger than the merit increase pools of around 3%.
				+ We return to this issue in Chapter 18.
	3. **Cash Compensation: Incentives**
		1. *Incentives* also tie pay increases to performance. However, incentives differ from merit adjustments.
			* An incentive program relies on an objective measure of performance (e.g. sales) usually in a formula-based way,
				+ Whereas a merit increase program typically relies on a subjective rating of performance.
			* They do not increase base wage and must be re-earned each pay period.
			* The potential size of incentive payment will be known (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.
			* 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.
		2. Incentives can be tied to the performance of an individual employee, a team of employees, a total business unit, or some combination of individual, team, and unit.
			* The performance objective may be expense reduction, volume increases, customer satisfaction, revenue growth, return on investments, and increase in stock value—the possibilities are endless.
		3. Because incentives are one-time payment, 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**.
		4. Incentives can have powerful effects, both good and bad.
			* On average, these effects are positive and substantial.
			* However, incentives are risky.
				+ One example is the Great Financial Crisis, which apparently stemmed in large part from improper and aggressive incentives.
				+ These were paid to encourage loan officers to give home loans to people who were unlikely to be able to pay them back.
	4. **Long-Term Incentives**
		1. Incentives may be short- or long-term.
			* Long-term incentives are intended to focus employee efforts on multiyear results.
				+ Typically in the form of stock ownership or options to buy stock at a fixed price.
				+ The belief 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.
		2. Stock options are often the largest component in an executive pay package.
			* Some companies extend stock ownership beyond the ranks of executives.
	5. **Benefits: Income Protection**
		1. Exhibit 1.5 showed that benefits, including income protection, work/life services, and allowances, are also part of total compensation.
			* Some income protection programs are legally required in the United States;
				+ Employers must pay into a fund that provides income replacement for workers who become disabled or unemployed.
			* Employers also make half the contributions to Social Security.
		2. Medical insurance, retirement programs, life insurance, and savings plans are common benefits.
			* They help protect employees from 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 U.S., employers spend roughly $725 billion per year on health care costs – 19% of all U.S. health care expenditures
				+ The cost to provide family coverage is $21,342 per year per employee.

The average employer pays 74% and the employee pays 26%.

* + - * + Employers have sought to reduce benefit costs by shifting costs to employees.
				+ Other companies have allowed benefits costs to get out of control.

Chrysler, GM, and American Airlines went through bankruptcy to reduce benefits costs and labor costs.

* 1. **Benefits: Work/Life Balance**
		1. Programs that help employees 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); and
			+ flexible work arrangements (telecommuting, nontraditional schedules, nonpaid time off).
		2. Responding to the changing demographics of the workforce, many employers are giving a higher priority to these benefit forms – reinforced by the pandemic.
			+ Medtronic touts its Total Well-Being Program for its employees.
			+ They believe this program permits employees to be “fully present” at work and less distracted by conflicts between their work and life responsibilities.
	2. **Benefits: Allowances**
		1. Allowances often grow out of whatever is in short supply.
			+ In Vietnam and China, housing and transportation allowances are frequently part of the pay package.
				- Most foreign companies in China discover these allowances are expected.
				- Companies that resist must come up with other ways to attract and retain employees.
			+ In many European countries, managers assume a car will be provided.
	3. **Total Earnings Opportunities: Present Value of a Stream of Earnings**
		1. Up to this point compensation has been treated as something paid or received at a moment in time.
			+ But a firm’s compensation decisions have a temporal effect.
				- You accept a job offer at $50,000 a year.
				- If you stay for five years and get an increase of 4% a year, in five years you will be earning $60,833 a year.
				- For your employer, the five-year cost commitment is $331,649 and then add an additional 30% for benefits for over $430,000.
		2. A present-value perspective shifts the comparison of today’s initial offers to consideration of future bonuses, merit increases, and promotions.
			+ A company may tell applicants its low starting offer will be overcome by larger future pay increases.
			+ In effect, the company is selling the present value of the future stream of earnings.
	4. **Relational Returns from Work**
		1. Non-financial returns from work have a substantial effect on employees’ behavior.
			+ Exhibit 1.5 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, and receiving new uniforms.
			+ Such factors are part of the total return, which is a broader umbrella than total compensation.
			+ “Motivational purity bias” happens when candidates are evaluated lower when they seem to be motivated only by money.
	5. ***The Organization as a Network of Returns***
		1. It is useful to view an organization as a network of returns created by all the 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.
			+ The network of returns is more likely to be useful if bonuses, development opportunities, and promotions all work together.
			+ As a potential employee, look beyond the cash and health care offered to search for all the returns that create the network.

#### **A Pay Model**

* + 1. Exhibit 1.6 shows a pay model.
			- This pay model serves as both a framework for examining current pay systems and a guide for most of this textbook.
			- It contains three basic building blocks:
				* the compensation objectives,
				* the policies that form the foundation of the compensation system, and
				* the techniques that make up the compensation system.
	1. **Compensation Objectives**
		1. 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.
		2. *Efficiency*—can be stated more specifically:
			+ Improving performance,
			+ Increasing quality,
			+ Delighting customers and stockholders and
			+ Controlling labor costs
		3. Compensation objectives at Medtronic and Whole Foods are contrasted in Exhibit 1.7.
			+ Medtronic, pacemaker pioneer, emphasizes performance, business success, minimized fixed costs, and attracting and energizing top talent.
			+ Whole Foods first compensation objective is committed to increasing shareholder value.
		4. *Fairness*—(sometimes called equity) is a fundamental objective of pay systems.
			+ Medtronic’s pay objectives view fairness as a means to ensure fair treatment and recognize personal and family well-being
			+ Whole food’s pay objectives discuss a shared fate – pay beyond base wages is linked to team performance, and employees have some say about who is on their team.
			+ *Procedural fairness* refers to the process used to make pay decisions.
				- It suggests the way a pay decision is made may be equally as important to employees as the results of the decision (*distributive fairness).*
		5. *Compliance with laws and regulations*—**compliance** as a pay objective means conforming to federal and state compensation laws and regulations.
			+ As laws change, pay systems may need to change too.
			+ As companies go global, they must comply with the laws of all the countries in which they operate.
		6. *Ethics* – means the organization cares about how its results are achieved.
			+ Exhibit 1.8 shows one company’s code of conduct.
				- The challenge is to put these statements into daily practice.
				- The company here is Enron.
			+ Because it is so important, it is inevitable that managing pay sometimes creates ethical dilemmas.
				- Manipulated results to ensure executive bonus payouts
				- Misusing statistics used to measure competitors’ pay rates
				- Repricing or backdating stock options to manipulate 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
				- Shaving the hours recorded in employees’ time cards

These are all common examples of ethical lapses.

* + - * Some compensation professionals and consultants remain silent during ethical misconduct and outright malfeasance.
				+ Absent a professional code, compensation managers must look to their own ethics.
			* **Pay objectives** serve several purposes.
				+ They guide the design of the pay system and serve as the standards for judging the success of the pay system.

If an objective is to increase customer satisfaction, then incentive programs and merit pay might be used.

If the objective is to develop innovative new products, then job design, training, and team building may be used.

Policies and techniques are the means to reach the objectives.

* + - * + Objectives also serve as the standards for judging the success of the pay system.

If the best and brightest skilled employees are leaving for higher-paying jobs elsewhere, the system may not be performing effectively.

* 1. **Four Policy Choices**
		1. Every employer must address the policy decisions shown on the left side of the pay model:
			+ Internal alignment,
			+ External competitiveness,
			+ Employee contributions, and
			+ Management of the pay system.
		2. These are the foundations on which pay systems are built and they serve as guidelines for managing pay in ways that accomplish the system’s objectives.

*Internal Alignment*

* + 1. **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.
			- Internal alignment pertains to the pay rates both for employees doing equal work and for those doing dissimilar work.
				* Whole Foods tries to manage differences with a salary cap that limits the **total cash** compensation of any executive to 19 times the average cash compensation of all full-time employees.
				* However, the cap originally started at 8 times the average but attraction and retention problems were cited as a need for raising the cap several times.
				* The cap does not include stock options.
		2. 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.

*External Competitiveness*

* + 1. **External competitiveness** refers to pay comparisons with competitors.
			- 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.

Some employers set higher pay levels hoping to attract the best applicants.

This assumes that someone is able to identify and hire the “best” from the pool of applicants.

* + 1. External competitiveness decisions—both how much and what forms—have a twofold effect on objectives:
			- 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.
			- To control labor costs so that the organization’s prices of products or services can remain competitive in a global economy.

*Employee Contributions*

* + 1. How much emphasis should there be on paying for performance?
			- Should one programmer be paid differently from another if one has better performance and/or greater seniority?
			- Or should there be a **flat rate** for programmers?
			- Should the company share any profits with employees?
			- Share with all employees, part-time as well as full-time?
		2. Emphasis placed on **employee contributions** (or nature of **pay mix**) is a key policy decision since it directly affects employees’ attitudes and work behaviors.
			- Performance-based pay affects fairness.
			- Employees need to understand the basis for judging performance in order to believe that their pay is fair.
		3. What mix of pay forms – base, incentives, stock, benefits – do competitors use in comparison to the pay mix we offer?
			- Whole Foods combines base pay and **team incentives** to offer higher pay if team performance warrants.
			- Nucor targets base pay below market, but targets total cash compensation (including profit sharing and gain sharing/production bonuses) at well above the market median.
			- Medtronic sets its base pay to match its competitors but ties bonuses to performance.
				* Medtronic believes its emphasis on benefit 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 creates an advantage over competitors.
		4. The external competiveness and employee contribution decisions should be made jointly.
			- Clearly, an above-market compensation level is most effective and sustainable when it exists together with above-market employee contributions to productivity, quality, customer service, or other important strategic objectives.

*Management*

* + 1. Management means ensuring that the *right people* get the *right pay* for achieving the *right objectives* in the *right way*.
			- Managing compensation means answering the “So What?” question.
		2. 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.
			- The perspective is shifting from “How to” toward trying to answer the “So What?” question.
				* Costs are easy to measure, so the tendency is to focus there.
				* Yet the consequences of pay, though less amenable to measurement, are just as important.
	1. **Pay Techniques**
		1. The remaining portion of the pay model in Exhibit 1.6 shows the techniques that make up the pay system and are discussed throughout this book.
			+ Techniques tie the four basic policies to the pay objectives.
		2. Uncounted variations in **pay techniques** exist.

#### **Book Plan**

* + 1. The focus of this book is on the design and management of compensation systems.
			- **Part One, Chapters 1 – 2**, introduces the pay model which provides the structure for much of this book.
				* Chapter 2 discusses how to formulate and execute a compensation strategy.
		2. 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 at the core of the pay strategy.
			- **Part Two, Chapters 3 – 6**, focuses on *internal alignment* and examines pay relationships within a single organization.
			- **Part Three, Chapters 7 – 8**, examines *external competitiveness* – the pay relationships among competing organizations – and analyzes the influence of market-driven forces.
		3. Once the compensation rates and structures are established, other issues emerge.
			- **Part Four, Chapters 9 – 11**, focuses on *employee contributions,* the third building block in the model, examining issues related to
				* How much to pay each employee?
				* How much and how often should an employee’s pay be increased and on what basis?
				* Should pay increases be contingent on performance?
				* How should the organization share its success with employees?
		4. In **Part Five, Chapters 12 – 13**, we cover employee services and benefits.
			- How do benefits fit in the company’s overall compensation package?
			- What choices should employees have in their benefits?
		5. In **Part Six, Chapters 14 – 16**, we cover systems tailored for special groups (sales representatives, executives, contract workers, and unions) and provides more detail on global compensation systems.
		6. **Part Seven, Chapters 17 – 18**, discusses critical issues related to *managing the compensation system*.
			- Including the government’s role in compensation as well as understanding, communicating, budgeting, and evaluating the results of managing a compensation system.
		7. Even through the book is divided into sections that reflect the pay model, pay decisions are not discrete.
			- All of them are interrelated.
		8. The intent throughout the book is to examine alternative approaches.
			- There is rarely a single correct approach, alternative approaches exist or can be designed.

#### ***Caveat Emptor* – Be an Informed Consumer**

* + 1. Students and future managers need to be informed consumers of compensation research.
			- They must be able to understand the state of knowledge—what is and isn’t known.
			- It pays to read research.
			- Some studies are irrelevant and poorly performed, but not reading research literature might turn one into a prey for the latest business self-help fad.
		2. A consumer’s guide, that includes three questions, is provided to evaluate research studies.
	1. **Is the Research Useful?**
		1. How useful are the variables in the study?
		2. How well are they measured?
		3. Does the research measure anything useful?
	2. **Does the Study Separate Correlation From Causation?**
		1. 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.
		2. Many research studies use a statistical analysis known as *regression analysis*.
			+ One output from a regression analysis is the R2.
			+ The R2 is a squared correlation that tells us what percentage of the variation is accounted for by the variables we are using to predict or explain.
				- 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.
		3. Too often, studies and surveys are presented as revealing cause and effect.
			+ They do not.
	3. **Are There Alternative Explanations?**
		1. The best way to establish causation is to account for competing explanations, either statistically or through control groups.
			+ The point is alternative explanations often exist.
			+ And if they do, they need to be accounted for to establish causality.
		2. 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.

**VIII. Your Turn: Compensation at the World’s Largest Company**

***Summary of Case***

This case study instructs students to find Walmart’s Environmental, Social & Governance Report from the current year and previous years. The questions guide the students into exploring minimum pay levels, diversity, and supply chains in both the U.S. and in other countries.

***Discussion of Case Issues***

Do you think Walmart received good press for announcing it was increasing associate pay by $1? Did all employees receive higher pay? What about Walmart’s discontinuation of its quarterly bonuses? Is Walmart paying a living wage in the U.S.? Is Target or Amazon paying a living wage? How about in other countries? Are you aware of employee diversity at your local Walmart? Why do you think Walmart spends so much time and energy on enforcing their Standards for Suppliers? Do you think this helps the company more, or the suppliers more?

***Teaching Guidelines***

Use this case to stimulate a discussion on living wage and minimum wage in general.

Some students may feel Walmart is performing admirably by using its purchasing power to address societal issues. Other students may feel Walmart has such policies to insure they are managing their risk associated with bad media attention.

***Discussion of Case Questions***

1. **What is the minimum pay at Walmart? What is the average pay at Walmart? To what degree has each changed year to year?**

If the student goes back to Walmart’s 2018 Global Responsibility Report, they may find the statement that “In the final weeks of FY2018, we announced plans to increase the starting wage for all full- and part-time hourly associates in the U.S. to at least $11 per hour. As of April 2018, Walmart’s U.S. average full-time field hourly wage was $14.08.” If the student goes one additional step back to 2017, they find Walmart maintained a $9/hour wage for new hires, with a $1 increase if the employee finishes a three month training course. There is also a statement that pay was increased to $10/hour for all associates hired prior of January 1, 2016.

New hires in 2019 started at $11 an hour or more. The average wage of full-time, hourly employees was $14.26.

In 2020, the minimum starting hourly wage is $11/hour or more, and the average wage is “more than $14.00 per hour.”

In the 2021 Summary report (viewed before final report is released), the average hourly wage of Walmart workers is $14.61 but there is not a figure listed for starting hourly wage for new hires. Another source provided the fact that the minimum starting hourly pay is raising from $11 to $12. There is a highlighted side-note reading: $15.25 per hour is the average wage as of March 2021, after wage increases were implemented.

In 2017, the minimum starting wage was $9, raised to $10 after a 90-day training program. The minimum wage increased at the very end of 2018 to $11 per hour and stayed at that rate through 2020. In 2021, that minimum would increase to $12 per hour. The average full-time hourly pay has slowly increased from $14.08 in 2018 to $15.25 in 2021 (after pay increases are implemented). It should be noted the company is discontinuing its quarterly bonuses it has paid hourly employees for decades. In addition, the $1/hour pay increases Walmart has touted will only affect a third of its current hourly workforce, centered on workers in the deli, bakery, and auto center roles. Walmart is also raising the minimum starting wage for all hourly workers by $1 – which at the new $12/hour Walmart’s starting wage is still below the starting wage at Target or Amazon, both currently at $15/hour.

Sources:

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<https://mycbs4.com/news/local/walmart-will-end-its-quarterly-employee-bonus-program-after-raising-base-pay-by-1-an-hour>

<https://corporate.target.com/press/releases/2020/06/target-increases-starting-wage-to-15-thanks-frontl>

<https://www.cnbc.com/2021/04/28/amazon-to-hike-wages-for-over-500000-workers-to-up-to-3-an-hour.html>

<https://corporate.walmart.com/newsroom/2020/09/17/investing-in-our-associates-and-roles-of-the-future>

1. **Promotion to higher job levels is the main way that pay increases over the course of one’s career. What are the promotion opportunities like at Walmart? How much opportunity is there for career and pay growth?**

The reports state that in both 2020 and 2019 Walmart promoted “more than 200,000” and 210,000 associates to jobs with higher pay and more responsibility. Assuming total employment at 2.6million, that equals about 8% of hourly associates are promoted. Note that these numbers are down from earlier years with promotion of 230,000 associates in 2018. The 2020 and 2019 reports also note that 75% of their in-store management members began as hourly workers. The 2018 and 2019 reports state that key department manager roles can earn as much as $24.70 per hour. With the new job descriptions and the change to a team approach announced in 2021, team lead roles start at between $18 and $21 an hour and can go up to $30 an hour.

Source:

<https://corporate.walmart.com/newsroom/2020/09/17/investing-in-our-associates-and-roles-of-the-future>

1. **To what degree has Walmart achieved desirable levels of diversity and inclusion? What steps is the company taking to improve in this area?**

The Culture, Diversity & Inclusion (CDI) scorecard was introduced in 2016 to give upper management a visual representation of both women and people of color proportions compared to retail composites and national composites. Walmart generally falls just slightly behind retail composites and slightly above national composites for their total workforce. Their attention to diversity and inclusion appears to be working as these numbers are up from previous years. The numbers in the 2021 summary report project their numbers for both people of color and women to be above both retail and national composites. According to the 2020 report 27% of the board of directors are women. Four principles guide their approach to fostering inclusion: objectivity, transparency, data-driven decisions, and accountability.

1. **How does Walmart describe its approach to safeguarding the treatment of workers (including fair pay) in its supply chain?**

Walmart believes they have the purchasing capabilities to improve their supply chain conditions. Walmart makes their expectations clear in their Standards for Suppliers policy (implemented in 1992) which promotes transparency and enables enforcement with a monitoring systems that focuses on audits on geographies with the greatest potential for problems. Walmart expects their suppliers to abide by local labor and employment laws, not use involuntary or underage labor, recruit responsibly, maintain a fair process for making employment decisions, provide a safe work environment, and comply with all laws regarding compensation, working hours, and freedom of association and collective bargaining.

1. **We know that Walmart keeps a careful eye on compensation cost of its employees, as part of its strategy of keeping its product prices low. What about workers it does not employ, but that are in its supply chain? Of what relevance is Walmart’s supply chain (and the workers in it) to Walmart keeping its prices low?**

Walmart expects their suppliers to comply with the Standards for Suppliers policy. According to the 2020 report, Walmart has stopped doing business with 35 suppliers (since 2012) in response to serious violations of their Standards for Suppliers. Walmart is committed to addressing potential risks to the dignity of workers in a minimum of 10 retail supply chains by 2025, focusing on reducing forced labor and promoting worker safety and gender equality. According to the 2020 report: “Retail supply chains can create economic opportunity for the millions of people around the world who produce food and other products.” By elevating these workers, they are creating future customers as well as increasing their standing in the eyes of judgmental consumers world-wide who demand sustainable supply chains. On the other hand, the supply chain is important to Walmart keeping its prices low. The less Walmart pays for an item, the lower the price they can charge and still make a profit. Walmart relies on the suppliers, and the supplier’s low labor costs, to keep their own prices low.

**6. Walmart recently announced a commitment to sourcing $10 billion in India-made goods by 2027. (**[**https://corporate.walmart.com/newsroom/2020/12/10/walmart-commits-to-sourcing-10-billion-of-india-made-goods-each-year-by-2027**](https://corporate.walmart.com/newsroom/2020/12/10/walmart-commits-to-sourcing-10-billion-of-india-made-goods-each-year-by-2027)**). Search the web for data on wage levels (minimum wage or actual wages) in India. How do wages in India compare to those in the United States? How will sourcing more goods from India help Walmart with its low price strategy? Where else does Walmart source from and how do wages in those countries compare to those in the United States?**

 India’s national-level minimum wage is around U.S. $2.80 per day. This is well below the U.S. national minimum wage standard of $7.50 per hour. Sourcing items from India will allow Walmart to sell products at very low cost while still maintaining a fairly high profit margin. According to the 2020 report, Walmart sources from approximately 2,900 suppliers. The minimum pay in Mexico is U.S. $10.73 per day. South Africa is another supplier where the minimum wage is about U.S. $1.40 per hour. Harnessing the lower costs of goods and services from these countries allows Walmart to offer products at a lower cost while still maintaining a reasonable profit margin.

Sources:

<https://www.india-briefing.com/news/guide-minimum-wage-india-2021-19406.html/#:~:text=India%20offers%20the%20most%20competitive,geographical%20areas%20and%20other%20criteria.>

<https://www.mexperience.com/mexicos-minimum-wage-2021/#:~:text=Mexico's%20minimum%20wage%20was%20raised,the%202020%20rate%20of%20%24185.56.>

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**IX. Still Your Turn: Who Are Amazon’s Peer Companies for Comparing Compensation?**

***Summary of Case***

The case notes a *Wall Street Journal* article that states that Amazon has “thin margins by tech standards.” The article compares Amazon to their “peers” at Google, Apple, Facebook, and Microsoft. Further, if unionization is successful at Amazon, their labor costs will increase and will wipe out their already thin margins. The case raises the question of why Amazon is being compared to other tech companies as opposed to Walmart. The case then instructs students to gather annual reports from Walmart and Amazon and compute revenue per employee and also the ratio of operating income to revenue by each of their three business segments.

**Note:** Walmart’s 10-k report for Fiscal 2021 – fiscal year ending January 31, 2021 – was used for the following computations. For Amazon, the computations reflect numbers from the 10-k report for fiscal year ending December 31, 2020.

First, compute revenue per employee for Walmart and Amazon. (At Amazon, use net sales as revenue.)

**Amazon**: Total net sales was $386,064,000,000 with 1,298,000 employees equals $297,429.89 of net sales per employee.

**Walmart**: Total revenue was $559,151,000,000 with 2,300,000 associates equals $243,109.13 of revenue per employee.

Second, compute the ratio of operating income to revenue by business segment for Walmart and Amazon. Each company has three business segments.

**Amazon**: North America, International, and Amazon Web Services (AWS).

Net sales for North America is $236,282,000,000 with $8,651,000,000 in operating income is 0.0366 or 3.7%

Net sales for International is $104,412,000,000 with $717,000,000 in operating income is 0.00686 or 0.69%

Net sales for AWS is $45,370,000,000 with $13,531,000,000 in operating income is 0.29823 or 29.8%

**Walmart**: Walmart U.S., Walmart International and Sam’s Club.

Net sales from Walmart U.S. was $369,963,000,000 and operating income was $19,116,000,000 or 0.0516 or 5.2%

Net sales for Walmart International was $121,360,000,000 and operating income was $3,660,000,000 or 0.0301 or 3%

Net sales for Sam’s Club was $63,910,000,000 and operating income was $1,906,000,000 or 0.0298 or 3%

**Note:** while Walmart’s total revenue was used to compute the revenue per employee, Walmart’s net sales were used to compute the operating profit margin ratio.

Sources:

<https://stock.walmart.com/investors/financial-information/sec-filings/sec-filings-details/default.aspx?FilingId=14814446>

<https://ir.aboutamazon.com/sec-filings/sec-filings-details/default.aspx?FilingId=14665784>

<https://www.thebalancesmb.com/what-is-the-operating-profit-margin-ratio-393205>

***Discussion of Case Issues***

In the original *Wall Street Journal* article why *are* Amazon’s “peers” listed as Google, Apple, Facebook, and Microsoft as opposed to Walmart? Is Amazon a tech company? (Read the Competition section at the beginning of the 10k statement where Amazon lists its 9 current and potential competitors.)

***Teaching Guidelines***

There are a few topics to possibly discuss. Use this case to stimulate a discussion on the perceived fairness of Walmart and Amazon’s wages in relation to the amount of revenue generated per employee.

Some students may feel neither company is paying fair wages while other students may believe both Walmart and Amazon are paying adequately, given their strategies.

***Discussion of Case Questions***

1. **How do the revenue/employee numbers compare across companies?**

Even though Walmart made more than $173 billion than Amazon in revenue, Amazon made $54,320.76 more per employee than Walmart. This is because Amazon has a million less employees than Walmart.

1. **How does the ratio of operating income to revenue compare across segments within and across the companies? Focusing on Amazon, how do these operating income/revenue ratios differ across its segments?**

Within Amazon, the ratio of operating income to revenue varies considerably across segments with the International segment being the lowest at 0.69%, North America the next highest at 3.7% and the AWS ratio being the highest at 29.8%. For Walmart, the ratios are relatively stable across segments with 5.2% for Walmart U.S., 3% for both Walmart International and Sam’s Club. If you are comparing Amazon, North America and Walmart U.S., you see that Walmart has a safer ratio than Amazon (5.2% compared to 3.7%) but these numbers would be more helpful if compared to other retail chains. Specifically for Amazon, its Web Service segment has the highest ratio at 29.8%, but again, this only gains significance when compared to other companies offering web service.

1. **We will see what choosing peer companies to compare compensation includes those that are product market competitors, as well as labor market competitors. Based on the ratios you have computed and examined, who are Amazon’s product market competitors?**

According to Amazon’s 10k report, their product competitors are ‘physical, e-commerce, and omni-channel retailers, publishers, vendors, distributors, manufacturers, and producers of the products we offer and sell to consumers and businesses.’ Barnes-n-Noble could be a competitor for bookseller or Zappos could be a competitor for clothes and shoes – but neither can compare with Amazon’s employee numbers (23,000 and 1,500, respectively). When looking at Amazon’s web service segment, the leaders in the industry is Amazon, Microsoft, and Google. It would helpful to know total employee size in order to compare them more effectively. Amazon may need to be compared to others depending on segment rather than in total.

Sources:

<https://www.barnesandnobleinc.com/faqs/>

<https://fortune.com/best-companies/2015/zappos-com/>

<https://www.c-sharpcorner.com/article/top-10-cloud-service-providers/>

1. **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.

1. **Review Questions**
	* 1. **How do differing perspectives affect our views of compensation?**

From a societal perspective, compensation may be viewed as:

* a measure of productivity.
* a measure of the inherent equity and justice in a society (examine the wages of similarly situated men versus women, blacks versus whites, etc.).
* a cause of tax increases (public employee wages) or cost-push inflation (increased wages cause higher production costs, which may be passed on as price increases for goods and services).
* a reason for job losses (or gains) within a country over time.
* a prelude to price increases.

From a stockholder perspective, compensation may be viewed as:

* a mechanism to increase stockholders’ wealth.
* a key method to link executive pays to company performance.

From a customer perspective, compensation may be viewed as:

* a means of keeping prices low – and they reward Walmart for this strategy.
* one factor in judging a company’s values.

From a managerial perspective, compensation may be viewed as:

* a major expense to be managed.
* a means to influence employee work attitudes and behavior, which affect productivity.

From an employee perspective, compensation may be viewed as:

* a return for services rendered.
* a reward for meritorious performance.
* an indicator of the worth of an individual’s skills or training.
* a major determinant of economic and social well-being.
	+ 1. **What is your definition of compensation? Which meaning of compensation seems most appropriate from an employee’s view: return, reward, or entitlement? Compare your ideas with someone with more experience, someone from another country, someone from another field of study.**

“Traditional” college students will most likely focus on direct compensation only, since most students in this category will have expenses beyond their present earning capacity. “Non-traditional” students are more likely to focus on the total returns from work—cash compensation, benefits, and relational returns. When students compare their definition of compensation with others, it is hopeful they will gain a broader view of compensation. Be sure to emphasize that people’s perspectives will vary; the differences in perspectives are likely to differ based on a combination of various factors such as age, occupation, family status, etc.

* + 1. **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?**

The “network of returns” an instructor receives will depend on the type of college or university (example—research versus teaching orientation) he/she attends. Potential examples are provided below. Relational returns, moving beyond compensation and benefits are stressed upon.

If an instructor attends a research university, the most appropriate network is the probability to explore the chosen field of academics in detail, along with the ability to receive appropriate grants, scholarships, and be able to publish papers with ease. Laboratory facilities, opportunities to conduct case studies and organizational research should be available easily. In case the instructor is working within a team, it is essential that the university provide the team with advanced technologies to be able to communicate and carry out research. However, if an instructor attends a college whose mission is focused on teaching (e.g. small, liberal arts colleges), the most appropriate network would probably include extensive facilities that allow the instructor to access the latest studies, so as to be able to correlate the knowledge with the syllabi. Access to libraries, the Internet and attendance at seminars and conferences related to the instructors’ subject should be encouraged and the instructor must ideally be given a free hand in being able to explore various academic avenues within the scope of the syllabus and expanding and encouraging the spirit of questioning and understanding within the students.

If the network is changed, teaching effectiveness could be affected. Academia typically provides higher pay for research effectiveness when compared to teaching effectiveness. Student recommendations will vary depending on the type of college or university attended.

* + 1. **What are the four policy issues in the pay model? What purposes do the objectives in the pay model serve?**

The four policy issues in the pay model are: (1) internal alignment; (2) external competitiveness; (3) employee contribution; and (4) management of the pay system.

The basic objectives include efficiency, fairness, ethics, and compliance with laws and regulations. Efficiency can be correlated to improving performance, increasing quality, delighting customers, and stockholders, and also to controlling labor costs. Fairness is a fundamental objective that ensures fair treatment of all the employees by recognizing both employee contributions. Compliance as a pay objective means conforming to federal and state compensation laws and regulations. Ethics means the organization cares about how its results are achieved.

* + 1. **List all the forms of pay you receive from work. Compare your list to someone else’s list. Explain any differences.**

The different forms of pay will definitely depend on the types of jobs a student has held and the nature of his/her work experience. The various types of pay include: (1) pay received directly as cash, including base, merit, incentives, and cost-of-living adjustments; (2) pay received indirectly (benefits), including retirement, medical insurance, paid time off, and programs to help balance work and life demands; and (3) relational returns, including the psychological, non-financial returns (e.g. recognition and status, employment security, challenging work, opportunities to learn, personal satisfaction from successfully facing new challenges, and teaming with great co-workers).

Comparisons of the types of pay will depend on the student’s current and prior work experiences and the comparison person’s work experiences. For example, students could compare financial incentives, such as piece rate production for a manufacturing position or commission pay for a sales position. Indirect pay benefits may include health insurance, life insurance, dental insurance, optical insurance, and prescription drug plans.

* + 1. **Answer the three questions in the *Caveat Emptor—Be An Informed Consumer* for any study or business article that tells you how to pay people.**

**Note:** Student responses will vary depending on the type of compensation article the student selects for analysis. To gain the maximum benefit from discussing this question, the instructor may want to assign a specific article for analysis. The following response to the three questions is based on research studies referenced in Chapter 1.

**(1) Is the research useful?**

Many studies use managers’ opinions as measures of success. For example, Rynes, Colbert, and Brown (2002; see footnote #85) conducted a study that surveyed 5000 HR managers and compared their beliefs to the research evidence in several areas and identifies seven common and important misconceptions held by managers. The study authors concluded that being unaware of the key research finding may prove costly to organizations.

The types of variables used in research studies and how they are measured significantly impact the quality of the research results. For example, many studies purport to measure organization performance. However, there is a lack of agreement on which variable(s) to use to measure performance. This is evidenced by the many variables used to assess performance: accounting measures (return on assets or cash flow), financial measures (earnings per share or total shareholder return), operational measures (scrap rates or defect indicators), qualitative measures (customer satisfaction), and opinions of managers (i.e. how effective is your gain-sharing plan?).

Thus, answering the question, “is the research useful?” requires separating opinions from facts as well as assessing the value of the variables and how they are measured. Opinion data is just that—data about opinions. It demonstrates what people think or believe is occurring but may not indicate what is actually going on. Studies conducted on a compensation survey data showed HR executives reporting that their respective firms’ target pay level was well above the median.

**(2) Does the study separate correlation from causation?**

Empirical research studies typically employ statistical analysis techniques to analyze the variables of interest. The correlation coefficient is a common measure of association and indicates how changes in one variable are related to changes in another. A study conducted to explore the extent to which employee participation in the job evaluation process during the implementation of a compensation system influenced pay satisfaction, showed that increasing the involvement of employees in implementing a pay plan would increase their satisfaction with pay. The results indicated the level of employee participation in the job evaluation project did not correlate significantly with any aspect of pay satisfaction. Thus, a relationship did not exist between employee participation and satisfaction.

On the other hand, even if the results had indicated a relationship existed between increased levels of employee participation and satisfaction with pay, this relationship (measured by the correlation coefficient) does not ensure causation. For example, just because an organization involves its employees in a job evaluation program and their satisfaction with pay increases, it cannot be concluded that employee involvement caused an improvement in their satisfaction with pay. Other explanations—length of time since last pay increase, percentage of last pay increase, and pay grade level of the employee’s job—may lie beneath the results. While the increased levels of employee participation and satisfaction with pay are associated, causation is a tough link to make.

Research on compensation often attempts to answer questions that do not involve causality. For example, the results of the study by Rynes, Colbert, and Brown (2002; see footnote #85) indicate a discrepancy between academic research findings and the beliefs of HR executives in several content areas of HR. This is a descriptive study, focused on providing benchmarking information; causation is not suggested.

**(3) Are there alternative explanations?**

Research studies focused on compensation often examine the impact of a certain type of pay program (i.e. merit or performance-based pay, team-based pay, gain-sharing) on a measure of organizational performance (i.e. customer satisfaction, company performance, productivity, quality) over a period of time. Researchers typically want to demonstrate that the introduction of a pay program will improve performance. Consider a hypothetical study with the following research question—if the performance measure improves during the time frame covered by the study, was the pay program responsible? Assuming performance improves, was the pay program responsible? Or, was some other variable responsible for the increased performance (i.e. change in leadership, use of new supplier vendors, and change in operating procedures)?

The best way to establish causation is to explore competing explanations for the improved performance results, either statistically or through the use of control variables. Research methodology emphasizes or “requires” that alternative explanations need to be accounted for to establish causality. It is often difficult to disentangle the effects of a pay program to clearly establish causality. However, it is essential to examine the overall pattern of evidence to make judgments about the effects of a pay program.

For example, it was found in a study of seven organizational characteristics, that the one that best predicted simulated organizational choice was pay for individual (versus team-based) productivity.