Part 4 Compensating and Managing Human Resources

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Chapter 10 Compensation: Base Pay and Fringe Benefits*

OBJECTIVES

After reading this chapter, you should be able to

1. Understand the traditional model for base pay programs.
2. Describe the basic approaches to job evaluation.
3. Describe the contemporary trends in compensation.
4. Explain the role of government in compensation.
5. Understand the various forms of fringe compensation, including government-mandated programs.
6. Define the different types of retirement plans.
7. Understand the complexities of international compensation.

OVERVIEW

The Tribune Company developed a new performance management system, closely following the prescriptions provided in Chapter 7. At an orientation session in which the new system was introduced to management, the first several questions had to do with the relationship between the new system and pay. Pay is very important to people and very important to organizations. Research on high-performance work systems indicates that characteristics of a firm's compensation system are strongly related to corporate financial performance.[1]

In December 2010, private employers in the United States spent an average of $27.75 per hour worked on total employee compensation. Cash compensation averaged $19.64 per hour (70.8 percent of total compensation) while per hour benefits costs were $8.11 (29.2 percent of total compensation).[2] Figure 10-1 depicts these average per hour compensation costs and the percent each component bears to overall compensation. But the general perspective about pay programs looks bleak. A February 2011 survey identified salary as the leading cause of employee dissatisfaction among U.S. workers (47 percent), followed by workload (24 percent), lack of advancement opportunity, and the individual's manager or supervisor (both at 21 percent).[3] In his book, *The Big Squeeze, New York Times* reporter Steven Greenhouse asserts, "A profound shift has left a broad swath of the American workforce on a lower plane than in decades past, with health coverage, pension benefits, job security, workloads,

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Figure 10-1
Average Employer Costs per Hour Worked

	Cost	Percent
Total compensation	$27.75	100
Wages and salaries	19.64	70.8
Total benefits	8.11	29.2
Paid leave	1.89	6.8
Vacation	.96	3.5
Holiday	.60	2.1
Sick	.24	.9
Personal	.09	.3
Supplemental pay	.75	2.7
Insurance	2.22	8.0
Retirement and savings	.97	3.5
Legally required benefits	2.28	8.2
Social Security and Medicare	1.64	5.9
Unemployment insurance	.21	.8
Workers' compensation	.42	1.5

Source: Adapted from the Bureau of Labor Statistics (Private Industry Employees, December, 2010). Accessed April 19, 2011, from http://www.bls.gov/news-release/pdf/ecac.pdf

stress levels, and often wages growing worse for millions of workers" (p. 4). While the productivity of the U.S. workforce rose more than 15 percent between 2001 and 2008, the average wage for the typical American worker increased by 1 percent.[4] Between January and July 2009, pay was frozen in half of U.S. companies. (Most of these freezes were lifted by late 2010.[5]) A 2009 survey reported that only 30 percent of organizations believe that supervisors and line managers communicate and manage pay programs effectively.[6]

The term **compensation refers to all forms of financial returns and tangible benefits that employees receive in exchange for their time, talents, efforts, performance and results.**[7] As the business environment becomes increasingly complex and global, the challenge to create and maintain effective compensation programs, given cost constraints, also requires greater professional expertise, organizational understanding, creativity, and vision than ever before.

Four trends

Over the last decade, several compensation trends are noteworthy. First, there has been a dramatic increase in the diversity of pay strategies and practices. Not too long ago, employees received a base salary (which the organization probably described as being "competitive") and a set of preestablished benefits (which the organization probably described as being "comprehensive"). Today firms are providing variable pay, special recognition bonuses, individual and group incentive plans, and broad-based success-sharing programs at all levels in the organization, and flexible benefits are becoming the norm.

Diversity in strategies

Soaring benefits costs

The second trend has been the soaring cost of employee benefits. There is general consensus that our traditional approach to health care is "unsustainable," but there is little consensus about how to effectively revise the system. In the private sector, traditional pension plans have been replaced with less costly programs, which will provide considerably lower retirement benefits. In the public sector, pension plans and other benefits are under siege in many places because of their high price tags and because taxpayers bitterly resent funding benefits for public workers that exceed those to which most taxpayers are entitled as private sector workers. The future of Social Security and Medicare are in question.

Third, there continues to be significant pay inequity when comparing pay at the "top" of the firm with pay at the "bottom." In 1980, CEOs earned 42 times the average worker; by 1990 that figure had increased to 120 times; and in 1997 the ratio was 280 to 1. The disparity peaked in 2000 when CEOs earned 531 times the average worker in the firm. In 2009, it was estimated to have fallen back to 263 to 1.[8] According to experts, "U.S. CEOs are far and away the highest paid CEOs in the world. Yet, from a long-term perspective, and compared to CEOs in other countries, they cannot be considered the very best performers."[9] In a 2010 study, for every additional 10 percent increase in revenues in the private sector, 3 percent of those revenues went straight to CEO compensation.[10] The 2008 collapse of major U.S. financial institutions, which were managed by extremely well-paid executives, only added fuel to the fire. While Merrill Lynch's 2008 losses soared to $27.6 billion, its

45-year-old top investment officer's 2008 pay was $33.8 million in cash and stock, a bit less than he was awarded in 2007. In fact, while Merrill's very survival was in question, 11 of its executives were paid more than $10 million each, and an additional 149 employees earned more than $3 million. The issue of such rewards in the face of record losses created public outcry, particularly when the federal government stepped in with taxpayer dollars to cover Merrill's losses.[11]

Pay programs to communicate change

The fourth key trend is that pay programs are increasingly being used to communicate major change in organizations, particularly during and after major downsizing and reengineering efforts. As IBM began to rebuild itself in the late 1990s, one of the key tools for change was a complete redesign of the pay system. IBM scrapped its traditional approach to evaluating work and its pay grade structure. It reduced the number of different jobs from 5,000 to fewer than 1,200. It significantly increased the percentage of an individual's pay that was directly related to performance and created pay-at-risk programs at all levels in the organization (a big first for IBM!).[12] Although HR and compensation experts continued to design and develop the framework of the pay program, significant day-to-day administration of the program was transferred to line managers, making compensation more of a management tool than an HR program. Compensation experts have traditionally argued the importance of directly aligning business strategies and compensation programs. This past decade, however, has seen a rethinking of the role that compensation programs play in supporting, communicating, and even leading the way to new organizational values and performance norms.

A state of transition

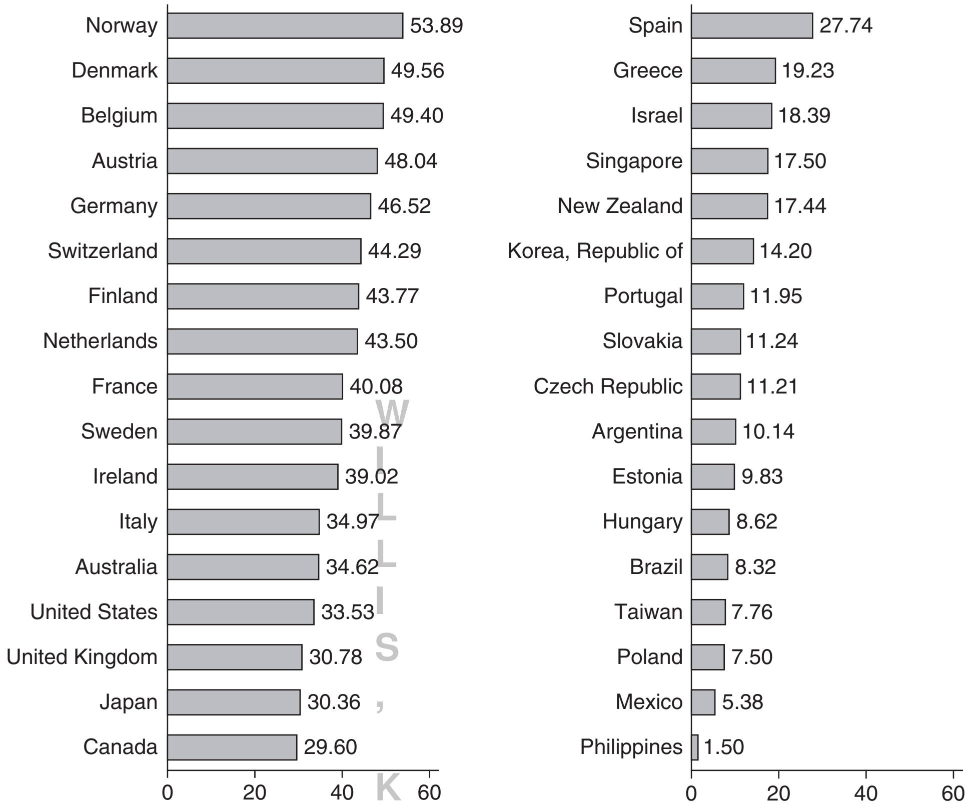
As a result, compensation programs are in a state of transition. Organizations are experimenting with different types of structures; they are allocating money differently to programs; they are questioning the traditional (rather rigid) "job-based" approach to compensation program design; they are looking for innovative ways to get more for their investment in compensation; and they are putting more of a focus on long-term success criteria.

Does pay matter?

Does pay matter? Research suggests that reward systems can influence a company's success (or failure) in three ways.[13] First, the amount of pay and the way it is packaged and delivered to employees can motivate, energize, and direct behavior. IBM's compensation program redesign (described previously) was directly targeted at changing the way IBMers thought about their work, focused their energies, and directed their performance. Second, compensation plays an important role in an organization's ability to attract and retain qualified, high-performance workers. Unless applicants find job offers to be appropriate in terms of the amount and type of compensation, they may not consider employment with a particular firm. Compensation strategies and practices can clearly shape the composition of a workforce. This is especially important for firms operating in tight, high-expertise labor markets. Microsoft, for example, sets out to hire a certain percentage of the top technical talent that graduates each year. In addition to investing heavily in recruiting and selection activities, Microsoft offers job candidates a generous sign-on bonus, a competitive base salary, stock options, and a flexible benefits program, which allows individuals to select the benefits and coverage that they both need and value most.

Finally, the cost of compensation can influence firm success. On average, the overall cost of labor is estimated to be 65–70 percent of total costs in the U.S. economy and is similarly substantial elsewhere.[14] Within the United States, firms that wish to pursue a strategy based on cost leadership must find ways to reduce those costs without sacrificing quality. Organizations that compete in global marketplaces have greater cost-competitive pressures. In 2009, average hourly total compensation costs (cash compensation plus benefit costs in U.S. dollars) for a U.S. manufacturing worker was $33.53, which was lower than costs in 12 European countries and Australia, but higher than the costs of 20 other countries tracked by the U.S. Bureau of Labor Statistics (BLS). Norway reported the highest per hour manufacturing compensation costs ($53.89), while the Philippines posted the lowest ($1.50). Mexico's average hourly compensation cost $5.38. Across Europe, the average hourly cost was $31.95 (21 countries tracked). Figure 10-2 presents an international comparison of hourly compensation costs in manufacturing. The U.S. Bureau of Labor Statistics also reports that average compensation costs (U.S. dollars) in manufacturing for China have increased from $0.62 per hour (in 2003) to $1.36 per hour (2008). In India, those costs

Figure 10-2
International comparison of hourly compensation costs in manufacturing (in U.S. dollars-2009)



Source: Bureau of Labor Statistics (USDL 11-0303).

have increased from \$0.81 (2003) to \$1.17 (2007).[15] While the BLS reports average hourly compensation costs for China and India, it researches and presents them separately from European and Western Hemisphere data. This is because Chinese statistics on manufacturing employment do not tend to conform to international standards, and India's employment statistics only cover "organized manufacturing" (which represents about 20 percent of India's manufacturing sector). However, these labor cost increases reported for both countries suggest that competitive cost advantages enjoyed by China and India may be showing signs of some erosion. In summary, then, the strategy and structure of compensation programs have important implications for businesses and their ability to create and sustain competitive advantage.

Does compensation matter to individual workers? Recent discussions suggest that money motivates people on two basic dimensions. The instrumental meaning of money relates directly to what money buys: better houses, better educations for children, better vacations, clothes, and cars. The symbolic meaning of money concerns how wealth is viewed by ourselves and within our society in general. In the United States, "rich" is usually equated with "successful," "intelligent," "diligent," and "highly motivated," while "poor" tends to be equated with "failure," "unmotivated," "uneducated," perhaps "lazy" and "slovenly." One discussion of the issue pointed to all the money-oriented slang expressions used in our culture as an indication of the value of material possessions: "put your money where your mouth is," "crime doesn't pay," "paying the piper," "hitting pay dirt," "you get what you pay for," and "there is no free lunch."[16]

U.S. workers prefer individual pay-for-performance

In job situations, money motivates behavior when it rewards people in relation to their performance or contributions, when it is perceived as being fair and equitable, and when it provides rewards that employees value.[17] Research supports the belief that U.S. workers prefer pay that is based on their own performance—not the performance of the team, group, or company. In one study, employees reporting the strongest preference for individualized rewards were also the highest-performing employees.[18] Research also indicates that employee satisfaction with pay is correlated with organizational commitment and trust in management, while it is inversely related to absenteeism, seeking alternative employment opportunities, voluntary terminations, pro-union voting, and incidents of theft.[19] It is also interesting to note that the particular components of pay have different value to different people. Research indicates that younger people tend to focus predominantly on cash compensation. As people age, however, their preference tends to shift to benefits and workplace flexibility.[20] It should be no surprise that life stage, career stage, and individual circumstances create differences in compensation preferences.

What makes an employee satisfied with pay? Research indicates that individuals differ in the way in which they conceptualize pay satisfaction.[21] According to **equity theory,** pay satisfaction is a function of the comparison of an individual's input–outcome ratio with his or her perceptions about the input–outcome ratios of referent others. In other words, people compare themselves to others, focusing on two variables: inputs and outcomes. Inputs refer to individuals' characteristics (e.g., education, previous work experience, special licenses), effort (e.g., how long they persist in seeking a solution to a problem), and performance (e.g., number of units produced). Outcomes are what people get out of their jobs (e.g., pay, promotion, recognition). It's important to note that these comparisons are based on perceptions, rather than on any objective, or quantifiable, measures of actual inputs and outcomes. Also important is that these judgments are made in terms of ratios—that is, relationships of "equal to," "greater than," or "less than." Pay satisfaction occurs when people perceive that they are paid appropriately in relation to others. When employees feel underpaid, they are dissatisfied and may withhold effort or engage in negative or counterproductive behaviors. What happens when these comparisons suggest that a worker is overpaid? Originally, researchers hypothesized that individuals would feel guilty and would work harder or smarter in order to close the gap. More recent evidence suggests that employees whose comparisons and perceptions indicate that they are overpaid tend to rethink their comparisons in order to find (or rationalize) a more equitable balance.

Does compensation matter at the societal level?

Does compensation matter at the societal level? Over the course of history, societies that produced more also enjoyed higher standards of living. This means that their citizens enjoyed higher qualities of life, including better transportation systems, higher levels of education, more luxuries, better health care, and more time off.[22] In addition, governments tend to use higher standards of living as platforms for social change. Legislation such as the Fair Labor Standards Act (which includes the minimum wage and child labor rules), the Employee Retirement Income Security Act (ERISA), the Equal Pay Act (EPA), the Pregnancy Discrimination Act, and the Age Discrimination in Employment Act (ADEA) are aimed at ensuring that people are treated justly and that the poorer and less powerful members of society are protected from flagrant abuse. Former president Bill Clinton championed legislation to limit the tax deductibility of excessive executive compensation. Remember that organizations deduct the compensation they pay to employees as a business expense when they calculate their taxes. Excessive compensation to high-level employees, then, actually reduces the amount of taxes paid by a corporation. Who makes up the shortfall? Clinton's law limited an organization's deduction to $1 million for the compensation it paid to any individual in any year unless the pay was specifically and explicitly based on performance.

At the same time, some argue that the relatively high cost of U.S. labor, in general, is the principal reason that the United States has trouble competing globally in certain industries. Some assert that industry setbacks can be traced to product price increases necessitated by the unreasonable wage and benefits demands of its workers. Two-tier pay systems are becoming more common in some industries (e.g., automotive, airlines) where newly hired employees are paid at a significantly lower rate (and with fewer benefits) than other employees doing the same work.

Five Objectives for Effective Compensation

An effective compensation system typically has the following five objectives.

1. It enables an organization to attract and retain qualified, competent workers.
2. It motivates employees' performance, fosters a feeling of equity, and provides direction to their efforts.

3. It supports, communicates, and reinforces an organization's culture, values, and competitive strategy, especially long-term strategy.
4. Its cost structure reflects the organization's ability to pay.
5. It complies with government laws and regulations.

Attract and retain employees

Motivate employees

Compatible with long-term strategy

Ability to pay

As organizations ponder changes to their compensation systems, they should consider all five of these objectives. The ability to attract highly qualified individuals can be determined by **selection ratios** and vacancy rates. The ability to retain can be ascertained by looking at voluntary termination rates, perhaps in combination with performance appraisal data (high turnover rates among the highest performers would be a sign that compensation system changes may be in order). Employee surveys may provide insights into motivation levels of workers. The compatibility of pay with corporate culture and competitive strategy can be examined by looking at employee surveys, performance appraisal data, and other performance indicators. And the cost structure should be assessed relative to the compensation packages that competitors pay for the same type of work. Employees are very sensitive to changes in their compensation. Major changes to their compensation can have a profound effect on these objectives, for better or for worse.

Numerous federal, state and local laws and regulations

Of course, all these considerations exist in the context of the numerous laws and regulations that affect compensation. This last objective is quite a challenge and perhaps more so since 2008. Although some federal laws (e.g., the National Labor Relations Act, discussed in Chapter 13, and the Employee Retirement Income Security Act) preempt state laws, employers could be subject to state and local laws and regulations in addition to the major federal laws described in this chapter. Many states increased their minimum wage in 2012 above the federal minimum wage, and 20 states (and the District of Columbia) now protect workers against discrimination on the basis of sexual orientation and/or sexual identity. Three states (California, Washington, and New Jersey) currently require paid family leave. As we discussed in Chapter 3, Title VII and ADEA "disparate impact" lawsuits involving allegations of pay discrimination are quite common.

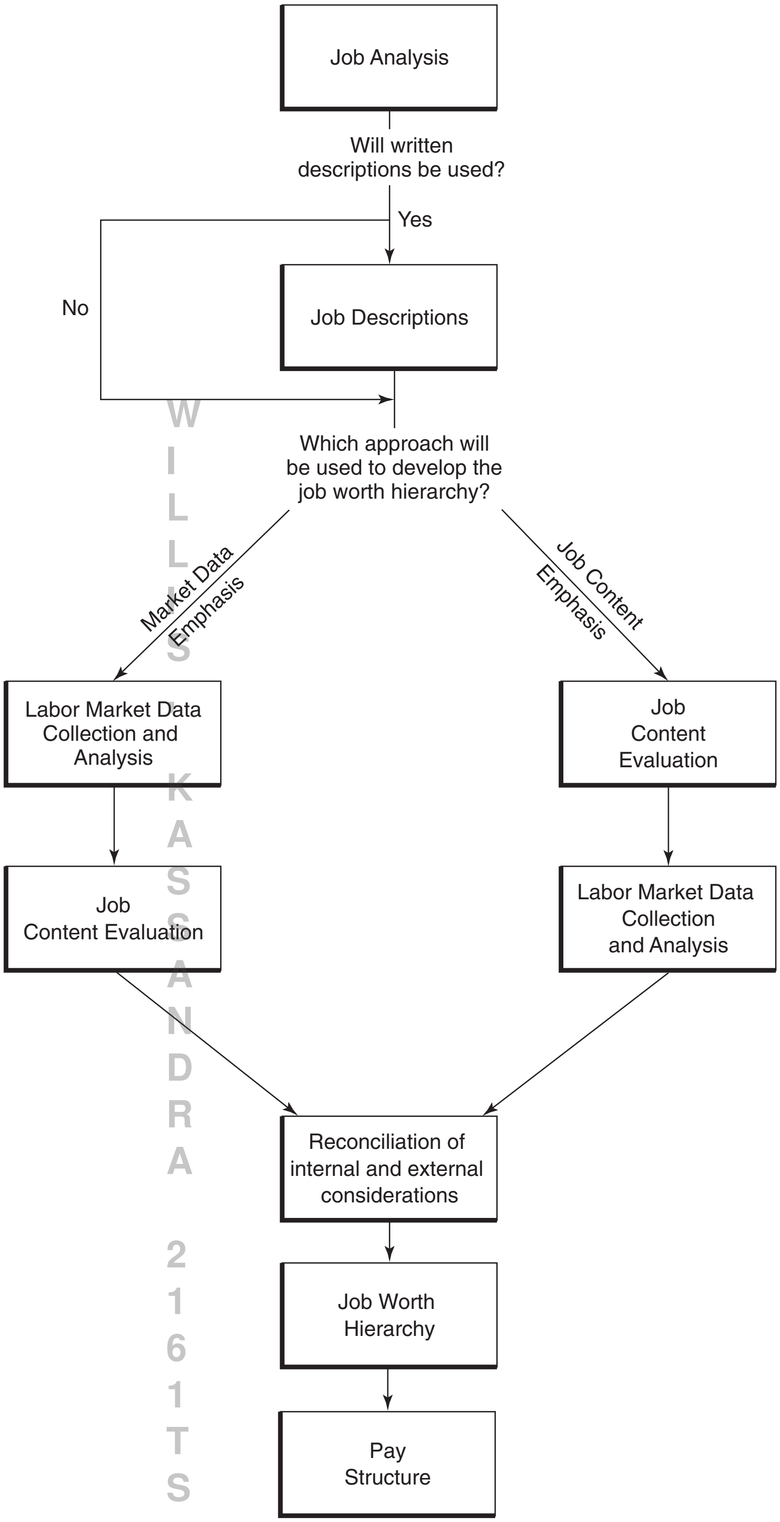
Compensation is divided up into two parts. **Cash compensation** is the direct pay provided by employers for work performed. Cash compensation has two elements: base pay (e.g., hourly or weekly wages plus overtime pay, shift differential, uniform allowances) and pay contingent on performance (e.g., merit increases, incentive pay, bonuses, gain sharing). **Fringe compensation** refers to employee benefits programs. Fringe compensation also has two dimensions: legally required programs (e.g., Social Security, workers' compensation) and discretionary programs (e.g., health benefits, pension plans, paid time off, tuition reimbursement). This chapter covers *base pay* programs and *fringe benefits.* Pay that is contingent on measures of performance is covered in Chapter 11.

As indicated earlier, compensation systems are in a state of transition. Traditional designs focus primarily on attracting and retaining qualified workers and complying with government regulations. Newer pay models balance these concerns with increased attention to motivating and directing performance and to aligning pay with achieving important firm effectiveness goals.

CASH COMPENSATION: BASE PAY

The traditional model for structuring base pay programs has existed in its relatively unchanged form for more than 50 years.[23] In the 1800s business owners knew their employees, their performance, and their financial needs, and individual pay was established on that basis. As businesses grew, bureaucracies were created to provide structure, organization, and direction. Professional managers replaced business owners, while rapidly growing hierarchies distanced them from most workers. Efficiency and effectiveness became the most important business objectives. In the late 1800s, Frederick Taylor designed a formal, systematic way of assigning pay to jobs while helping a steel company identify methods for improving productivity. His methodology came to be called **job evaluation.**

Figure 10-3
The Traditional Approach to Compensation



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In the following sections, we describe the traditional approach to base pay administration, examine some recent trends in base pay program design, and discuss the government's role in shaping employer practices in cash compensation. Figure 10-3 depicts and summarizes the steps involved in creating and installing a traditional compensation plan.

THE TRADITIONAL APPROACH TO COMPENSATION

What Is Internal Equity?

In an internally equitable program, individual employees perceive that their position is paid fairly in relation to other jobs in the organization. Compensation programs use job evaluation to create internal equity among jobs.

Job evaluation is defined as the process of assessing the value of each job in relation to other jobs in an organization. Traditional job evaluation tends to be job based versus market based. In other words, job evaluation focuses on the duties and responsibilities assigned to a job. It's important to note that traditional job evaluation does not directly consider the credentials or characteristics of the person who occupies the job, or the quality or quantity of the individual's performance. Traditional job evaluation is described as an objective procedure that measures such things as the complexity of the work, the amount of responsibility, its potential strategic impact, and the level of effort required of each position in relation to other positions in the organization. Traditional job evaluation typically results in a hierarchy of jobs ranked in order of their relative worth (or value) to the firm.

Three steps to job evaluation

The job evaluation process typically involves three steps. During step one, work analysis is conducted. You will recall from the discussion in Chapter 4 that work analysis is the process of collecting and evaluating relevant information about jobs. During this step, job descriptions are usually drafted (or updated) and job specifications (KASOCs) are identified. See Chapter 4 for a full discussion of the methods and techniques for collecting information through job analysis. Step two involves actually rating the job. Once again, you may recall from Chapter 4 that some standardized approaches to job analysis provide compensation-related data, particularly O*NET and the Position Analysis Questionnaire. However, organizations tend to use some form of job evaluation specifically developed for use in determining relative worth and, ultimately, pay. Step three involves carefully reviewing the job evaluation results. This is typically done by arranging jobs in top to bottom (or bottom to top) order using the job evaluation results. At this point, it is important to study the evaluations in relation to one another. Consider this something of a "sore thumbing" process that looks at the final results of the job evaluation and identifies positions that don't appear to fit best where the job evaluation process has placed them. This is also the stage in which evaluators should try to identify judgmental biases that may have crept into the evaluation process.

Job Evaluation Methods

Three basic job evaluation approaches are most common: job ranking, job classification, and point-factor plans. Each of these methods is described and explained next. A summary of the approaches is provided in Figure 10-4.

The oldest, fastest, and simplest method of job evaluation, **job ranking** involves placing jobs in order from most valuable (or most important or most difficult) to least valuable (or least important or least difficult) using a single factor such as job complexity or the importance of the job to the firm's competitive advantage. This method typically looks at each job as a whole and does not examine the tasks that make up the job. Although it is the simplest method, ranking is seldom the recommended approach.[24] Typically, the ranking factor is not well-defined so that the resulting hierarchy is very difficult to explain

Figure 10-4 **Summary of Three Traditional Job Evaluation Methods**

Method	Procedure	Advantages	Disadvantages
Ranking	Rank order whole jobs for worth or compare pairs of jobs	Simplest method; inexpensive, easy to understand	Only general rating of "worth"—not very reliable; doesn't measure differences between jobs
Classification	Compare job descriptions to preestablished grade descriptors	Simple, easy to use for large numbers of jobs; one rating scale	Ambiguous, overlapping grade descriptors
Point factor	Reduce general factors to subfactors; give each factor weights and points; "score jobs"; use points to determine grades	More specific and larger numbers of factors; off-the-shelf plans available (e.g., Hay plan); more precise measurements	Time-consuming process; more difficult to understand; greater opportunity to disagree

Figure 10-5 **Grade Descriptors for Federal Job Classification System Serving as a Yardstick in Job Rating**

Grade GS-1

Includes all classes of positions the duties of which are to perform, under immediate supervision, with little or no latitude for the exercise of independent judgment, the following: (1) the simplest routine work in office, business, or fiscal operations; or (2) elementary work of a subordinate technical character in a professional, scientific, or technical field.

Grade GS-18

Includes all classes of positions the duties of which are: (1) To serve as the head of a bureau. This position, considering the kind and extent of the authorities and responsibilities vested in it, and the scope, complexity, and degree of difficulty of the activities carried on, is exceptional and outstanding among the whole group of positions of heads of bureaus. (2) To plan and direct, or to plan and execute, new or innovative projects.

to employees. In addition, since the approach focuses on the total job, often the highest-level duty becomes the basis for the evaluation. Finally, the ranking approach provides no information concerning how much more valuable one job is in relation to another, or how the KASOCs of one job relate to those of another. This could be a key drawback for an organization that is committed to employee development, internal mobility, cross-training programs, and career ladders.

Job Classification

The **job classification** method was originally developed, and continues to be used, by the federal government. Here each job is measured against a preexisting set of job levels that have been designed to cover the full range of work that would be performed by federal government employees. In other words, broad descriptions are designed in advance to reflect the characteristics of the jobs that would be placed at each level in that system. Job classification, then, involves comparing a specific position to these generic descriptors and deciding which level fits best. Figure 10-5 presents the generic descriptors for two job levels within the federal job classification system. The classification system is relatively inexpensive and easy to administer.[25] But as the number and diversity of positions grow, it is increasingly difficult to write level descriptors in advance that will cover the full range of jobs. When specific level descriptors don't exist, the classification method becomes unclear and difficult to communicate to workers. In addition, like the ranking method, it is hard to know how much difference exists between job levels. Finally, in any whole job rating system, one must be cautious about the same type of rater errors that can creep into performance appraisal (see Chapter 7). For example, a halo-type error might be committed when a rater is overwhelmed by one particular element of a job.

Point-factor plans

Under a **point-factor plan,** a variety of job-related factors are the basis for determining relative worth. Point-factor plans are the most widely used traditional job evaluation approach in the United States and in Europe. In choosing factors, the organization decides: "What particular job components do we value? What job characteristics will we pay for?" Companies should choose factors for a job evaluation plan that are based on the organization's strategy, that reflect the type of work performed, and that are generally acceptable to its stakeholders. Skill, effort, responsibility, and working conditions are the most common factors found in point-factor plans.[26] Figure 10-6 presents a summary of the three major factors within the well-known **Hay plan.**

Figure 10-6 **Major Factors of the Hay Plan**

Know-How

Sum total of every kind of skill, however acquired, required for acceptable job performance. Know-how has three subfactors:

1. Practical procedures, specialized techniques.
2. Ability to integrate and harmonize the diversified functions of management
3. Interpersonal skills.

Problem Solving

Original "self-starting" thinking required by the job for analyzing, evaluating, creating, and reasoning. Problem solving has two subfactors:

1. The thinking environment in which problems are solved.
2. The thinking challenge of the actual problems typically encountered by the position.

Accountability

Answerability for action and for the consequences of the action; the measured effect of the job. Accountability has three subfactors:

1. Freedom to act (personal control).
2. The impact of the job on end results (direct versus indirect).
3. Magnitude—the general dollar size of areas most affected by this job.

Figure 10-7 **Example of Degree Statements for the Factor "Physical Requirements"**

FACTOR: PHYSICAL REQUIREMENTS

This factor appraises the physical effort required by a job, including its intensity and degree of continuity. Analysis of this factor may be incorrect unless a sufficiently broad view of the work is considered.

Degree

1. Light work involving a minimum of physical effort. Requires only intermittent sitting, standing, and walking. (10 Points)
2. Repetitive work of a mechanical nature. Small amount of lifting and carrying. Occasional difficult working positions. Almost continuous sitting or considerable moving around. (20 Points)
3. Continuous standing or walking, or difficult working positions. Working with average-weight or heavy materials and supplies. Fast manipulative skill in almost continuous use of machine or office equipment on paced work. (30 Points)

A higher degree rating for a job translates into a greater number of job evaluation points

After the factors are identified and described, they are usually weighted because all factors are probably not equally important to an organization. Factors such as responsibility, decision making, and mental effort tend to be weighted more heavily than physical effort or working conditions. Next, *degree statements* and their point values are created. Sometimes called *factor scales,* these are statements of the extent to which the factor is present in any given job. Figure 10-7 illustrates a typical degree statement for the factor "Physical Requirements." When a position's evaluation is complete, the point scores on each factor are totaled. The more valuable a job is, the higher its total point score.

Point-factor breaks jobs into component parts

Unlike job ranking, point-factor plans do not rank jobs in an organization purely based on a comparison of one against another, and they do not rely on a rater's perception of the whole job. Instead, each job is examined concerning the degree to which each factor is present. In this way, the point-factor plan is similar to the classification approach in that it uses an external standard, evaluating each job in relation to that standard. Unlike the classification system, however, the point-factor approach breaks jobs down into component parts and assigns point values for various characteristics. In a point-factor plan, a job's relative worth is the sum of the numerical values for the degree statement chosen within each factor. A job hierarchy is derived by ranking jobs by their total point score.

Point-factor plans have a number of advantages.[27] The written evaluation enables an organization to trace, analyze, and document differences among jobs. Such differences can be the foundation for training, development, and career progression programs. The fact that jobs are broken down into parts and evaluated using the same criteria over and over again limits the opportunity for rater bias to enter the process. Finally, when explaining job evaluation to employees, point-factor plans tend to have a high level of credibility. On the other hand, point-factor plans are expensive to design or buy and they are time-consuming to install and maintain. Some experts recommend that point-factor plans should be administered by evaluation committees consisting of line operating supervisors, managers, rank-and-file workers, and union representatives (if relevant).[28] The time and cost of such commitments must be considered as part of the overall job evaluation costs.

Job families

Point-factor job evaluation is typically conducted within a *job family* in order to establish internal equity among similar types of work. While definitions differ a little, a **job family** is essentially a group of jobs having the same basic nature of work but requiring different levels of skill, effort, responsibility, or working conditions (e.g., entry versus senior level). For example, an Accounting job family might include Accounting Clerks, Accounting Assistants, Junior Accountants, Accountants, Senior Accountants, Accounting Supervisors, Assistant Controllers, and so on. A point-factor plan enables an organization to document the precise distinctions among the levels of work within a job family. Use of job families can also facilitate comparisons to the external marketplace.

In summary, in traditional compensation programs, an organization chooses a job evaluation approach that it believes will best meet its needs and systematically evaluates each job within or against that standard. **Within a traditional compensation plan, the goal involves creating not only an internally equitable program, but also one that is externally competitive.** The next group of activities focuses on considering pay practices in the marketplace so that the organization may effectively compete for qualified workers.

What Is External Equity?

The process of pricing jobs involves identifying the compensation provided by other organizations for jobs similar to yours. When your pay practices are similar to the practices of other organizations competing for the same talent, then your program is said to be competitive, or **externally equitable.** When we concern ourselves with external equity, we shift our focus from an administrative value system to an economic one. Thus, one should not expect the results of external surveying to match the results of job evaluation.[29]

Pay surveys

The principal tool for establishing external equity is **salary surveys.** Most organizations utilize some sort of survey information in order to approximate the prevalent pay practices in their particular marketplace. Within a traditional compensation program, comparing an organization's practices to those of the marketplace typically involves three steps: (1) planning the data collection activities, (2) collecting the survey information, and (3) analyzing the information.

Benchmark jobs

Planning to survey involves choosing which jobs will be surveyed. Typically, organizations survey benchmark positions. **Benchmarks** are well-known jobs, with many incumbents, that are strategically important and are structured in such a way that one would expect to find them in the general marketplace. Next the organization should decide what sources it will use for gathering market data. The least expensive and the quickest approach is to obtain data from public sources, such as local chambers of commerce, the U.S. Department of Labor (e.g., the O*NET), and various other state and local agencies. Another alternative is to purchase a survey from a consulting firm. These are more expensive than local or government surveys, but they are usually of higher quality. An organization can also conduct its own survey or can contract with an outside firm to conduct such a survey on its behalf. This is the most expensive option, but it typically provides the highest quality of information, since the company sponsoring the survey decides who will be invited to participate, which jobs will be covered, and the exact nature of the pay information that will be gathered. Check out salary.com, SalaryExpert.com, careerjournal.com, or the

O*Net for salary data

Occupational Outlook Handbook at stats.bls.gov for information related to benchmarking. Try http://online.onetcenter.org to get recent salary information for particular jobs in particular regions of the United States.

The activities involved in actually collecting survey data depend on whether the organization decides to purchase survey information or to sponsor its own survey. During this phase, it is important to make certain that job content is carefully matched to survey descriptions and that the information gathered is of the highest quality possible. If an organization is buying an existing survey, it must make certain that the data represent the

Relevant job market

relevant market. As discussed in Chapter 5, the geographical pool is expanding for many jobs. Internet recruiting and other improvements in technology now make it possible to consider regional, national, and global labor marketplaces in order to locate the best job candidates and/or the most cost-effective candidates. Effective surveys tend to go beyond base pay and provide information concerning all elements of compensation (e.g., eligibility for incentive pay and bonuses, time-off provisions, benefits provided). Good surveys provide information in addition to practices relating to existing workers and will include salary ranges, hiring ranges, recent pay increases, and other similar information.

Finally, when it comes to analyzing market data, practices vary widely among organizations.[30] Some organizations look at competitor pay data only very generally, using average salaries or median starting salaries, or some other index that it believes to be meaningful, to guide its decision making about its own pay policies. Other organizations invest considerable time, effort, and money analyzing data using least-squares regression analysis to aggregate data across jobs and across companies. An organization should choose the type and the depth of the analysis based on its own individual needs, the complexity of its marketplace, the amount of time the organization can afford to allocate to the project, the professional expertise that is available within the organization, and the resources that it is able and willing to spend for outside advice and assistance.[31] Figure 10-8 presents some best practices for surveying marketplace pay practices effectively.

Tie pay levels to market average for most jobs

In general, organizations tie their pay practices for most positions to the market average, although there are situations when organizations choose to pay above or below average based on their strategy or goals. For example, Merck, the highly successful pharmaceutical company, pays its research and development division above market for researchers with

Figure 10-8 **Getting the Most Out of Pay Surveys**

- Focus specifically on your business needs
  - What is your "relevant market"?
  - What jobs are strategically important to your business success?
  - In what jobs are you seeing "dysfunctional" turnover?
  - What steps are competitors taking that may put you at a disadvantage?
- Communicate with survey vendors and marketplace experts frequently
  - Treat surveying as an ongoing process, rather than as a periodic event
  - What early warning signs are occurring that could affect your ability to attract and retain key skills and capabilities?
  - What changes in technology are occurring that may affect you?
  - What's generally happening in your marketplace?
- Seek easy and effective access to good data
  - Will a particular survey provide good data in an easy to use format?
  - Can you manipulate the data provided in order to calculate other important statistics that your organization values?
  - What particular survey input and retrieval methods fit best with your technology?
- Avoid time-consuming data input approaches
  - If you have participated before, can prior data (that doesn't change often) be preprinted for you?
  - Can data be transferred electronically, rather than through manual, paper-driven formats?
- Stretch your survey budget
  - Some free surveys are worthwhile
  - Keep your eye on Job Boards
  - Talk to recruiters, headhunters and other subject matter experts (SMEs)
- Look for added-value activities
  - Attend meetings and formal presentations about the survey, data collection guidelines, and survey results
    - Bring SMEs with you if their perspective is important
  - Look for good surveys that provide free or reduced-price results for your participation
  - Provide feedback to surveyors about ways that future surveys can be improved

Adapted from Toman, R., & Oliver, K. (2011, February). Seven ways to get the most out of salary surveys. *Workspan. pp. 17–21.*

Paying above market

particular specialties that are compatible with Merck's strategic goals. One very interesting experiment in above-market compensation involves a New York City charter school that as of 2009 pays its teachers $125,000, plus a potential bonus based on the school's performance (about twice as much as the average New York City public school teacher earns). The school's founder is abiding by what research in education indicates: teacher quality is the key to student academic performance. It's too early to tell how this unique approach to compensation in education will work out. Organizations that are willing to train new employees may find that they can pay below market for such positions with the assumption that there is a learning curve.

How an organization structures its base salary program is primarily a matter of organizational philosophy, although marketplace practices are often important to consider in highly competitive situations. In structuring a program, several options are available. First, an organization can use a single rate structure in which all employees performing the same work receive the same pay rate. Second, an organization can use a seniority approach that focuses on how long an individual has been employed by the organization and/or in a particular job. Third, some organizations use a combination of seniority and a merit-based plan. For example, employees begin at a fixed rate, progress to higher rates during their first year based on time in the job, then any additional pay increase is awarded solely on the basis of performance. Yet another option would be a pay system based on productivity. An individual who is paid a sales commission is an example of this. A fifth and increasingly popular option could be some form of base pay with an incentive opportunity, either based on individual, team, unit, or company performance. As will be discussed in Chapter 11, a dominant trend is to separate the pay-for-performance component of compensation from the base pay component so that total compensation is more closely linked to recent performance indicators. Finally, many organizations combine elements of these approaches to create their own formal program. The most common traditional pay structure involves grouping similar jobs into pay grades and assigning a salary range, with

Separate pay-for-performance from base pay

Figure 10-9 **A Comparison of Four Contemporary Approaches to Pay**

Approach	Description	Advantages	Disadvantages
Market-Pricing	Pay established solely on the basis of marketplace comparisons and market value of jobs	Saves time by eliminating job evaluation process and/or other tools used to establish internal equity	Pay for unusual or unique jobs may be better established in relation to other jobs in organization Strategic importance of a job to an organization may be misstated General consensus suggests that internal equity considerations are important
Broadbanding	Replaces traditional narrow salary ranges (40–60 percent spread) with fewer, wider bands (200–300 percent spread)	More consistent with downsized, flatter organizational structures Breaks down previous structural pay barriers among jobs to facilitate empowerment, teamwork, etc. Greater flexibility; more useful managerial tool	Traditional cost control in pay structure is lost Job pricing may be more difficult May be more difficult to communicate to employees
Pay for knowledge	Employees paid on basis of either (1) degree of specific knowledge they possess; or (2) an inventory of skills	Encourages workforce flexibility and enhanced competence Fewer supervisors needed as employees improve knowledge and skill Fosters sense of individual empowerment about pay	Pay costs may get out of control Unused skills may get rusty Creating and maintaining skill and competency menus take time and effort Do we pay for inputs or outcomes?
Team pay	Any form of compensation contingent on group membership or team results	Reinforces concepts of teams, empowerment May better communicate and support organization's culture and goals	May demotivate top individual performers Few existing plans; beginning to emerge

a minimum, midpoint, and maximum.[32] The use of pay grades simplifies program administration. Rather than hundreds (or thousands) of unique pay rates, grouping jobs into grades typically means 10 to 25 pay grades (depending on company type and size). Pay ranges, as opposed to pay rates, also provide increased flexibility that enables managers to consider specific job-related characteristics of individual employees or job candidates. In traditional programs, employees typically progress through pay ranges based on a combination of seniority and merit.

In summary, then, this traditional pay model focuses on internal equity (through job evaluation), external equity (through market surveying), and some reconciliation of these to arrive at a final pay structure that fits well with the organization's strategy and goals and that will enable the organization to attract, retain, and motivate qualified employees. As indicated earlier, this general approach has dominated compensation practice for the past 50 years.

Over the past decade or two pay programs have evolved into new formats that represent a considerable break from the traditional approach. In this section, we describe noteworthy efforts in this direction. Figure 10-9 compares the characteristics of four contemporary pay approaches that are described next.

The Market Pricing Approach

As indicated earlier, the traditional approach to compensation uses a job-based approach to establishing internal equity. In other words, the duties assigned to a job are the focus of the job evaluation process. Then actual pay is linked to marketplace practices. Today, however, an increasing number of organizations bypass the time and expense of traditional job-based programs and go straight to the marketplace to find the wage information they need in order to set pay. This is called a **market pricing approach.** While recent evidence suggests that the popularity of this approach is growing, experts assert that it may not be effective for three reasons.[33] First, most companies have some unique jobs or job responsibilities that are more effectively priced in relation to other jobs (and responsibilities) within an organization than they are to similar jobs in the external marketplace. Second, the strategic importance of jobs within a particular company may be misstated if compared only with the external labor market. Third, there is a general consensus that market-based programs alone will not enable achievement of internal equity objectives. See Critical Thinking Application 10-A for further consideration of this issue in reference to executive pay.

Current Trends in Salary Administration

Broadbanding

Broadbanding is an approach to base pay that has received considerable attention in the business press.[34] In theory, it is considered to be more consistent with the broader, downsized, flatter organizations that exist today. Broadbanding involves consolidating existing pay grades and ranges into fewer, wider career bands. While a traditional pay range might be $30,000–$45,000 (i.e., 50 percent spread from minimum to maximum), a job band could be $25,000–$75,000 (i.e., 300 percent spread). Broadbanding provides greater flexibility in setting pay rates, and it provides considerably more latitude in defining work and in moving people around within an organization. Northern Telecom clustered more than 34 pay grades into 10 bands and replaced 19,000 job titles with approximately 200 generic job titles. General Electric collapsed 30 pay grades covering administrative, executive, and professional employees into five broad bands.

Hewitt Associates studied the experience of 106 organizations that replaced traditional pay grades with broad bands by conducting focus groups that included affected employees, the managers responsible for administering the new plans, and top organizational executives.[35] Employee groups asserted that broadbanding encourages developmental and lateral career moves and facilitates cross-functional teams because differences in titles, levels, and salaries are minimized. Managers agreed with these observations and added that they liked the greater flexibility the approach provided in setting and managing pay. Executives viewed bands as a mechanism that could be molded to support a business's organizational style, strategy, and vision. An American Compensation Association study of broadband organizations found that 78 percent considered the approach to be effective.[36]

Insufficient research has been conducted to date to indicate whether broadbanding is a long-term, effective pay model.[37] Traditionally, narrow pay grades and ranges place upper limits on an individual's earnings. Some experts argue that broadbanding could increase payroll costs without specifically fostering corresponding increases in worker productivity. Some argue that broadbanding is appropriate for higher-level positions only.

Pay for Knowledge, Competencies, or Skills

In these types of plans, employees are paid on the basis of either the degree of specific, technical knowledge they hold or an inventory of knowledge and/or skills that they possess.[38] These plans are based on the assumption that knowledge, skill, or competence will be translated into improved employee performance and, ultimately, superior organizational effectiveness. Advocates assert that such plans can increase worker productivity and product quality, while decreasing absenteeism, turnover, and accident rates. One survey studying HR practices in large companies reported that 56 percent of firms used pay for knowledge or skill with at least some employees.[39] **Paying for knowledge** has long been a viable pay strategy in scientific, technical, and professional disciplines in which expertise and innovation were sources of competitive, albeit intangible, advantage. Business schools, for example, typically pay considerably more for an assistant professor with a PhD than for an instructor with an MBA. Similarly, unionized professions, such as teachers and nurses, have strongly favored pay based on education and experience. These plans are based on the assumption that professional competence increases with training and longevity. As technology continues to move forward at its rapid pace, such plans are increasing in popularity.

The most modern application of this thinking can be found in organizations designing and implementing **skills-based pay.** Originally found in new, nonunion manufacturing organizations, interest in this approach has grown considerably. Although it is not used as widely as its publicity might indicate (only 5 percent of U.S. organizations are believed to have implemented some version of the approach), its influence has been felt in some industries, such as pharmaceuticals and telecommunications. In a typical skills-based pay plan, the array of knowledges or skills that the organization values becomes like a pay menu. Employees begin at an entry-level rate. Incremental pay increases are awarded as employees demonstrate knowledge, or mastery, of specific, additional skills. Three types of potentially useful skill enhancements have been identified: (1) skill depth

5 percent of U.S. corporations use skill-based pay

is increased when employees learn more about specialized areas, enhancing their ability to solve difficult problems and moving along a career track to becoming an expert, or master; (2) skill breadth is improved when employees learn more and different tasks, or jobs, in the organization; (3) self-management skills are increased when employees improve their abilities to organize and schedule work, to supervise work quality, and to perform other administrative tasks.

Pros and cons of skills-based pay

Supporters argue its merits: (1) the cross-training and acquisition of knowledge can create a flexible, empowered workforce; (2) fewer supervisors are needed; and (3) programs encourage employees to take responsibility for and control over their own development and their own compensation growth. Opponents assert that, first, potentially higher individual pay costs may be uneconomical unless they are offset by higher worker productivity. Second, unless skills are used regularly, they become rusty, although the pay for the skill may continue indefinitely. Third, depending on the growth and direction of the organization, employees can still reach the top of the skills-based pay scale, resulting in the same frustration that these plans are designed to remedy. Fourth, one very controversial issue is whether organizations should pay for inputs (e.g., individual credentials) or outcomes (performance). Skills-based pay represents paying for inputs. In contrast, some organizations believe that the best response to rising costs in uncertain environments is to put increasing amounts of pay at risk; that is, paying for outcomes, for the attainment of real individual, group, or organizational goals. Paying for knowledge, competence, or skills suggests that credentials hold potential performance value. When organizations pay on this basis, they should do so understanding that they are assuming the risk that these credentials will ultimately improve performance. One in-depth study of nine long-term, skills-based pay plans found that organizations committed to this type of pay can achieve noteworthy successes, but the programs require a great deal of attention in their design, implementation, and their ongoing management.[40]

Team Pay Plans

With the wide growth in the use of teams within organizations has come discussion concerning how team members should be compensated. There appears to be a general consensus that teams require a different compensation approach than for work that is organized for and performed by individuals. However, there currently appear to be more questions than answers.[41] In one study of 230 large U.S. organizations, Hay Associates reported that 80 percent were satisfied with their use of teams, but that only 40 percent were satisfied with the related pay program.

Five types of teams

One group of experts argues that it is important to distinguish between behaviors that a company values (as in teamwork) versus a true organizational form (as in teams). In addition, at least five types of teams have been identified: management teams, work teams, quality circles, virtual teams, and problem-solving teams. In sorting through the types and uses of teams, three criteria have been suggested as a basis for determining whether a team is a candidate for some kind of customized form of pay: (1) the team is the ongoing, relatively permanent form of work organization in use; (2) the work is truly interdependent; and (3) the team shares responsibility for its own work-related decision making.

Use broadbanding with profit-sharing for teams

Some experts recommend that team units use broadbanding in combination with incentive profit-sharing plans based on team results (see the next chapter). Depending on the environment, a division and/or organizational component may be added to the incentive plan as well. Some organizations report the use of pay-for-knowledge systems, particularly skills-based pay, as a compensation approach for teams.

Government Influence on Compensation Issues

In Chapter 3, you read about equal employment opportunity regulations that were enacted by the federal government to positively influence social change. The government also provides a legal framework about cash compensation within which organizations must operate. These rules ensure that minimum operating standards of fairness and humanity are applied to compensation matters in the employer–employee relationship.[42] Figure 10-10 summarizes the principal provisions of the most important federal regulations governing pay. Of course, as with most HRM activities, the reader should be aware that state, county, and local laws also may regulate pay policies.

Figure 10-10 **Summary of Laws Affecting Pay**

Laws	Provisions
Fair Labor Standards Act	Sets minimum wage (7.25 per hour in June, 2011), overtime pay requirements, and rules governing child labor.
Dodd-Frank Wall Street Reform and Consumer Protection Act	Requires that publicly-traded companies provide shareholders a non-binding “say on pay” vote on executive compensation, at least once every three years. Also requires that executives return all incentive compensation that was based on misstated financial filings up to three years after the filing occurred (“clawbacks”).
Equal Pay Act	Men and women must be paid the same when they hold “substantially equal” jobs in terms of skill, effort, responsibility, and working conditions (some exceptions apply).
Lilly Ledbetter Fair Pay Act	Changes the 1967 Civil Rights Act to allow workers to sue their employers for up to 180 days after receiving any paycheck that is discriminatory.
Davis-Bacon Act of 1931	Workers employed in construction industry must be paid at the prevailing local pay rate when working on government contracts.
Walsh-Healey Act of 1936	Workers employed in organizations providing goods to federal offices and projects must be paid the prevailing local pay rate for such work
Services Contract Act of 1965	Workers providing services to government offices and projects must be paid the prevailing local pay rate for such work.

The Fair Labor Standards Act (FLSA)

The broadest, most comprehensive legislation that affects cash programs is the **Fair Labor Standards Act (FLSA).** Enacted in 1938, the law focuses on three main areas: minimum wage, overtime pay, and child labor rules. In 1963, the **Equal Pay Act (EPA)** amended the FLSA to include a prohibition against pay differentials based on gender. The FLSA also requires that employers maintain detailed records of time worked and pay received by each employee. The record-keeping requirement is used to determine whether or not an organization has complied with the law.

Many lawsuits regarding overtime

The number of lawsuits filed against employers alleging violations of the FLSA (and state wage-hour laws) has more than doubled from 1,854 (filed in 2000) to 4,389 (filed in 2006). The Employer Policy Foundation (an employer-supported think tank) estimates that, if organizations were to fully comply with these requirements, the annual cost would be $19 billion per year.[43] For noncompliant organizations, the penalties can be steep. Since 2001, courts have ruled against such organizations as Citicorp ($98 million), UBS Financial Services ($87 million), Starbucks ($18 million), Perdue Farms ($10 million), T-Mobile ($4.8 million), and Bank of America ($4.1 million). In 2008, Wal-Mart was mired in about 80 wage-hour suits filed since 2006 with one jury award of $172 million to workers in California and a settlement in Pennsylvania ($78.5 million). The lawsuits included alleged violations of both the federal FLSA and state wage-hour laws, including failure to pay earned overtime, failure to pay vacation time (required in some states), failure to provide required meal and rest breaks, and compelling employees to work off the clock during training. Then, in July 2008, a Minnesota court judge ruled that Wal-Mart willfully had violated the state’s wage-hour laws *two million times*. Wal-Mart settled this case in early December for $6.5 million in back pay to the plaintiffs. Weeks later, on Christmas Eve 2008, Wal-Mart announced that it would pay more than half a billion dollars ($640 million) to settle 63 FLSA-related class-action lawsuits in various parts of the country; then in December 2009, it agreed to pay an additional $40 million to settle a Massachusetts class-action lawsuit. In May 2010, the retailer agreed to pay up to $86 million more to settle a class-action claim accusing it of failing to pay vacation time, overtime, and other wages to an estimated 232,000 former employees in California.[44]

Minimum wage is higher in certain states

The **minimum wage law** places a bottom limit on what an employer may pay. When the law was passed in 1938, the minimum wage was $0.25. As of 2012, the federal minimum wage for covered nonexempt employees is $7.25 per hour (passed in July 2009). Full-time workers earning the federal minimum wage earn about $15,000 per year, an amount that is below the federal poverty line.[45] Many states (and some cities) also have minimum wage laws. As of this writing, 18 states have minimum wages above the federal $7.25 per hour. As of 2012, eight states increased their minimum wage levels to adjust to inflation (using the Consumer Price Index). The highest of the group, Washington, raised the pay grade to $9.04 an hour. San Francisco topped all states, raising its minimum wage to $10.24 per hour–the highest such level for any American city. As of January, 2012, the minimum wage for Florida increased from $7.31 to $7.67 an hour.

Where an employee is subject to both the state (or city) and federal minimum wage laws, the employee is entitled to the higher of the two minimum wages. If an employee receives customer tips as part of his or her pay, an employer is required to pay only $2.13 an hour in direct wages under FLSA, provided that (1) the direct wage plus the tips received equals at least the federal minimum wage; (2) the employee retains all tips; and (3) the employee customarily and regularly receives more than $30 a month in tips. In addition to the federal rules, most states also have minimum wage laws relating to tipped employees. Once again, when state rules differ from federal rules, the tipped employee is entitled to the higher of the two. Seven states do not have special rules for tipped workers, thus requiring that tipped employees receive at least minimum wage for each hour worked (Alaska, California, Minnesota, Montana, Nevada, Oregon, and Washington). Visit the Department of Labor website (www.dol.gov) for a state-by-state breakdown of minimum wage law. A minimum wage of $4.25 per hour applies to workers under the age of 20 during their first 90 days of employment as long as they do not displace other workers. After 90 days of employment, or when the worker reaches age 20 (whichever comes first), the employee must receive a minimum wage stipulated in the FLSA.

There has been much discussion about whether minimum wage laws represent too much government involvement in the private sector and whether a minimum wage is healthy for an economy. Those in favor of the regulation argue that a minimum wage is necessary to ensure that employers do not take unfair advantage of workers. Opponents argue that the law actually puts people out of work because employers tend to eliminate jobs as the cost of doing business rises.

Overtime pay

The FLSA's **overtime** provisions establish 40 hours as the standard workweek and require that employers pay workers at least 1.5 times their regular hourly rate for all work in excess of 40 hours in any workweek (hence the expression, time-and-one-half).

Under the 2004 Department of Labor rules, workers earning less than $23,660 per year—or $455 per week—are guaranteed overtime protection. The flood of class-action lawsuits related to overtime eligibility appears to center on the actual work performed by exempt employees designated as "executives, administrative, professionals, computer workers, or outside salespeople." In order to qualify for the executive employee exemption, for example, all of the following tests must be met.

"Fair Pay" rules

- The employee must be compensated on a salary basis (as defined in the regulations) at a rate not less than $455 per week.
- The employee's primary duty must be managing the enterprise, or managing a customarily recognized department or subdivision of the enterprise.
- The employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent.
- The employee must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion, or any other change of status of other employees must be given particular weight.

Many of the issues under litigation appear to center on the meaning of the term *primary duty*. Regarding issues related to exempt versus non-exempt status, a helpful Department of Labor site is: http://www.dol.gov/whd/regs/compliance/fairpay/main.htm

Child labor laws

The **child labor** provisions restrict the employment of young people by organizations. These provisions cover workers who are under the age of 18. Typically, they specify the type of work a youth may perform and, in some cases, whether there are hour limitations connected to their employment. Sixteen and 17-year-olds may not perform "hazardous" work, including work that involves manufacturing, mining, equipment or machine operation, roofing, meat and poultry packing, and the like. In addition to hazardous work, 14- and 15-year olds may not hold such jobs as lifeguard, public messenger, ride attendant or operator at an amusement park, and the like. Fourteen and 15-year-olds cannot work more than 3 hours per day on a school day and more than 18 hours per week when school is in session. When school is not in session, they may not work more than 8 hours per day or 40 hours per week (check out www.dol.eta for a complete list of child labor guidelines). All states have child labor standards. When federal and state standards differ, the rule that provides the most protection applies.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The 2008 collapse of major U.S. financial institutions was the impetus for the Dodd-Frank Act, passed in 2010. Described as the response to "years without accountability for Wall Street and big banks" that created ". . . the worst crises since the Great Depression, the loss of 8 million jobs, failed businesses, a drop in housing prices, and wiped out personal savings," the act applies to publicly traded companies and addresses a wide variety of issues, including transparency for traditionally unregulated financial instruments and the like.[46] In addressing executive compensation and corporate governance, Dodd-Frank provides for shareholders to directly nominate corporate directors, requires that board compensation committees be composed only of independent directors, increases company disclosure concerning executive compensation, and mandates the needed mechanisms for these changes to occur. The two areas that relate to compensation most directly in Dodd-Frank are its "say on pay" and its "clawback" provisions.

"Say on pay" provisions require that publicly traded companies give their shareholders a nonbinding (or advisory) vote on executive pay, beginning with annual meetings involving the election of directors that occur on or after January 12, 2011. Such "say on pay" votes must be taken at least once every 3 years. In addition, shareholders will also have a "say on when" (or how often) their say on pay will be exercised (annually, biannually, or every 3 years). Similar shareholder votes must also be taken relating to golden parachute arrangements. Small businesses were given a delayed compliance schedule. The goal, of course, is to bring greater transparency and accountability to the business owners (i.e., shareholders) concerning board of director compensation decision making. Time will tell whether this law will materially affect executive compensation practices. In the U.K., following similar "say on pay" regulations (passed in 2003), executive compensation, in general, continues to rise.[47] In California, however, Jacobs Engineering failed to receive shareholder support for its pay proposals during its January 27, 2011, annual meeting. There was 44.8 percent support for Jacobs's proposal, while 53.7 percent opposed and 1.4 percent abstained. According to analysts, at issue at Jacobs was a 33 percent pay raise for the CEO in spite of below-median returns when compared with others in the industry. Jacobs's board approved the CEO pay increase in spite of the shareholder opposition (remember that say on pay is an "advisory" vote). In addition, Jacobs Engineering adopted a 3-year schedule for shareholder say on pay votes, while 67 percent of shareholders supported annual say on pay votes.[48] Jacobs Engineering's stock is part of the S&P 500 index.

The Dodd-Frank "clawback" provision requires the return of all incentive compensation that is based on misstated financial filings. This provision applies to all executives going back 3 years from the date of the incorrect filing. The Sarbanes-Oxley Act of 2002 included a clawback provision, but it contained only a 1-year "look back" and it applied only to CEOs and CFOs. While one group described Sarbanes-Oxley as ". . . 66 pages of well-meaning, but vague, legalese,"[49] between 2006 and 2010, the percentage of Fortune 100 companies with publicly disclosed clawback policies increased from 17.6 percent to 82.1 percent. Going forward, two big issues require clarification: (1) what (if any) will be the role of misconduct in determining whether the clawback provision will apply; and (2) how will the clawback amount actually be determined (i.e., what precise portion of the incentive compensation is attributable to the financial misstatement).

In general, there is growing concern among Dodd-Frank supporters that this law will fall considerably short of expectation. At the time of this writing, the law is 1 year old, and the president still needs to nominate leaders for several agencies that will direct the Dodd-Frank changes. In addition, the rule-writing process is way behind schedule: 385 new rules need writing to implement Dodd-Frank, and only 24 have been done thus far (41 were scheduled to have been written by now). There is growing belief that, if congressional and Wall Street opponents of the overhaul can drag their feet a bit more, they may be able to delay implementation until after the next election, when the opposition may be strong enough to back away from or dilute Dodd-Frank. In addition, Pricewaterhouse

Cooper's Annual Corporate Director's Survey (2010) reports that 58 percent of corporate directors surveyed do not believe that Dodd-Frank will sufficiently control CEO compensation.[50]

The Equal Pay Act (EPA)

Few EPA claims

The FLSA was amended in 1963 to include the **Equal Pay Act (EPA).** This provision requires that men and women be paid the same when they hold "substantially equal" jobs in terms of skill, effort, and responsibility that are performed under the same working conditions. The jobs need not be identical, but they must be substantially equal. It is job content, not job titles, that determines whether jobs are substantially equal. The EPA seems to have worked. Only two claims were filed with the EEOC in 2010.

EPA exceptions

The EPA provides for a few exceptions where pay differences are allowed. The EPA allows pay differences for the same job based on differences in job tenure, quality or quantity of performance, individual differences in education or experience, or some other factor other than gender. In correcting a pay differential, no employee's pay may be reduced. Instead, the pay of the lower-paid employee(s) must be increased.

One typical contemporary example is setting a pay rate for the same job that pays more than the pay for an incumbent with years of experience. Some departments within colleges of business now hire newly minted PhDs at a salary above the pay of a senior professor who teaches the same classes. The fact that the senior professor is a female and the newly hired, inexperienced assistant professor is a male does not mean the EPA has been violated. The market is a "reasonable factor other than gender." These exceptions are known as "affirmative defenses," and it is the employer's burden to prove that they apply. Thus, in this university example, should an EPA lawsuit be filed, the college of business would probably have to produce data showing that the competitive market requires the higher starting salary for new assistant professors.

Title VII can be used for pay discrimination claims

The filing of a claim under the EPA does not preclude pursuing a claim under Title VII. This can be important because the Civil Rights Act contains no provision stipulating job similarity. Plaintiffs who can establish that they have been paid a lower rate due to gender, race, color, religion, or national origin are eligible for judicial relief under Title VII, regardless of the job's similarity to other work. (See Critical Thinking Application 10-B.) Figure 10-11 presents a summary of the EPA and other forms of compensation discrimination.

Figure 10-11 **Equal Pay and Compensation Discrimination**

EQUAL PAY ACT

The Equal Pay Act requires that men and women be given equal pay for equal work in the same establishment. The jobs need not be identical, but they must be substantially equal.

It is job content, not job titles, that determines whether jobs are substantially equal. Specifically, the EPA provides:

Employers may not pay unequal wages to men and women who perform jobs that require substantially equal skill, effort, and responsibility, and that are performed under similar working conditions, within the same establishment. Each of these factors is summarized below:

Skill—Measured by factors such as the experience, ability, education, and training required to perform the job. The key issue is what skills are required for the job, not what skills the individual employees may have.

Effort—The amount of physical or mental exertion needed to perform the job.

Responsibility—The degree of accountability required in performing the job.

Working Conditions—These encompass two factors: (1) physical surroundings like temperature, fumes, and ventilation; and (2) hazards.

Establishment—The prohibition against compensation discrimination under the EPA applies only to jobs within an establishment. An establishment is a distinct physical place of business rather than an entire business or enterprise consisting of several places of business.

Pay differentials are permitted when they are based on seniority, merit, quantity, or quality of production, or a factor other than sex. These are known as **"affirmative defenses,"** and it is the employer's burden to prove that they apply. In correcting a pay differential, no employee's pay may be reduced. Instead, the pay of the lower-paid employee(s) must be increased.

TITLE VII, ADEA, AND ADA

Title VII, the ADEA, and the ADA prohibit compensation discrimination on the basis of race, color, religion, sex, national origin, age, or disability. Unlike the EPA, there is no requirement under Title VII, the ADEA, or the ADA that the claimant's job be substantially equal to that of a higher-paid person outside the claimant's protected class, nor do these statutes require the claimant to work in the same establishment as a comparator.

The Lilly Ledbetter Fair Pay Act

Fair Pay Act

Many employers keep salaries and raises confidential. Such was the case at the Goodyear Tire and Rubber Company plant in Alabama when Lilly Ledbetter discovered that over many years she had received smaller raises than men in comparable supervisory positions. The Supreme Court ruled in 2007 that Ms. Ledbetter had not filed a timely claim (within the 180-day deadline) under Title VII. The Lilly Ledbetter Fair Pay Act, which was signed into law in January 2009, essentially overruled the U.S. Supreme Court's decision against Ledbetter in which the Court held that the 180-day time limit for Ledbetter to have filed charges under Title VII began when she received the first discriminatory paycheck many years earlier, even when Ledbetter had no way of knowing that her paycheck was discriminatory due to Goodyear's pay secrecy policy. In the Lilly Ledbetter Fair Pay Act, Congress stipulated that a new 180-day deadline for filing pay discrimination charges begins each time an employee is issued a discriminatory paycheck. This law covers not only paychecks, but also pension checks, if they are based on a pay history that was discriminatory. This law also protects individuals who may have been "affected" by an act of pay discrimination. Thus it is conceivable that other family members, such as spouses and children, may be eligible in the future to file suits concerning acts of pay discrimination. Finally, these rules apply not just to gender discrimination, but to all discrimination classes protected under employment law (race, color, religion, national origin, age, and disability).

Prevailing Wage Laws

Several federal laws have been designed to make certain that workers employed on government contracts receive fair wages relative to other local workers. The three most important laws are the **Davis-Bacon Act** of 1931, the **Walsh-Healey Act** of 1936, and the **Services Contract Act** of 1965, and they cover federal contracts for construction, goods, and services, respectively. Typically, prevailing wage levels have been equal to union wage levels, which, in effect, create a higher minimum wage for federally funded projects. At the same time, these regulations ensure that large federal projects, awarded on the basis of competitive bids, do not create a decline in an area's wage rates.

Pay Equity or Comparable Worth Policy

Proposed to eliminate bias

One contemporary pay topic concerns the policy of **comparable worth** or **pay equity** introduced earlier in the chapter. First enunciated in 1934 and adopted as policy in 1951 by over 100 nations (not the United States), a comparable worth or pay equity policy requires a pay structure that is based on an internal assessment of job worth (i.e., a job evaluation process). It has been proposed as a means of eliminating gender and (occasionally) racial discrimination in the wage-setting process.

Should an electrician earn more than a first-grade teacher, or a custodian more than a librarian? These questions are almost always resolved by the labor market and the forces of supply and demand. Advocates for comparable worth or pay equity policies argue that occupations dominated by female workers are paid less than "comparable" male-dominated jobs because of systematic discrimination against women in the labor market. Thus to rely on the market is to merely continue with the systemic discrimination. A pay equity or comparable worth policy would require employers to establish wages that reflect similarities and differences in the "worth" of jobs for the particular organization, with "worth" derived from an internal study that typically uses a point-factor job evaluation method but then links points (which define the "worth") to wages *across* job families and then mandates comparable pay based on comparable points. Thus market forces for any particular job are not the primary basis for setting rates.

Pay equity studies use point-factor job evaluation

Comparisons *across* families to determine equity

Pay equity assumes that the traditional method of achieving equity within, but not between, job families is inherently unfair. The theory of "within but not between" assumes, for example, that clerical jobs are compared to each other, that skilled trades jobs are compared to each other, and that professional jobs are compared to each other. The problem with this assumption is that jobs are typically not compared across job families. Thus a skilled trade job evaluated at 400 points on a point-factor plan might be paid 20 percent higher than a clerical job receiving the same number of points, due to different labor market rates. In Washington State, for example, the average wages of women were 20 percent lower than those of men for jobs found to have the same number of job evaluation points. Thus jobs in the clerical families may have shared equitable pay, but they were systematically lower than wages paid to men in traditionally male-dominated jobs, such as skilled trades. Advocates of comparable worth maintain that the labor market undervalues the economic worth of jobs performed predominantly by women and minorities.

Traditionally, the lower-paid job families included many women's jobs. For a number of reasons, job families with a large proportion of "female-dominated" jobs (defined in most comparable worth studies as jobs where more than 70 percent of the incumbents are women) have been compensated at a lower rate than have job families with many "male-dominated" jobs. According to the Bureau of Labor Statistics, in fact, 80 percent of U.S. female workers are employed in occupations in which at least 70 percent of all employees are women.[51]

Arguments against pay equity

Opponents to comparable worth pay policies present three arguments against the idea. First, they argue that, for most situations, there is no legal mandate to pay comparable worth salaries. Second, they argue that a comparable worth approach would mean inflating salaries relative to the external market and that most companies could not afford to do this and stay in business. In the state of Washington, for example, it was estimated in 1986 that providing a pay plan based on a comparable worth policy carried an annual cost of $400 million. Third, opponents argue that if women really want to advance in terms of salary, they can do so by preparing themselves to enter traditionally male-dominated jobs where they will enjoy the same pay—a right that is protected legally. This argument relies on an assumption that, over time, as women migrate away from lower-paid jobs because they can obtain more lucrative pay in other careers, the pay for such traditionally female work will rise to reflect the worker shortage.

Male vs. female wage differences reduced under pay equity policy

There is little question that differences between male and female wages are reduced under a pay equity policy. Women in Sweden, for example, earn 92 percent of what men earn under a long-standing pay equity program. The United Kingdom, Ireland, Switzerland, and Australia provide additional examples of wage gap decreases after pay equity programs were implemented. No country in the world pays women as much as men. (Sri Lanka, just southeast of India, leads the world in this regard, paying women, on average, 96 percent of what men earn.)

Paycheck Fairness Act

Various forms of federal pay equity legislation are pending before Congress. For example, the **Paycheck Fairness Act** was reintroduced in 2010 (it's been around since 1999). An amendment to the EPA, the law would establish "equal pay for equivalent work." For example, within individual companies, employers could not pay jobs that are held predominately by women less than jobs held predominately by men if those jobs are equivalent in value to the employer. The bill also protects workers on the basis of race or national origin. Like the EPA, the Paycheck Fairness Act makes exceptions for different wage rates based on seniority, merit, or quantity or quality of work. Other versions of "fair" pay legislation are also before Congress.

As of 2012, according to the **National Committee on Pay Equity,** 20 states have some form of pay equity policy for segments of the workforce. Seven states have comprehensive pay equity policies for all or almost all employees who work for those states. Bills have been introduced in over 25 state legislatures since 2000. However, as of January 2012, no major pieces of state legislation had passed since 2002. Check out www.pay-equity.org for recent activity.

As has been typical to justify legislative action, advocates of a pay equity policy for employees of the state of Florida conducted a pay equity study to document what they regarded as "systemic" discrimination against women and minorities in the manner in which the state had been paying its employees. Known as **"policy capturing,"** the study derived the predictive dollar value for the factors of the "point-factor" system in order to "capture" the historical policy linking job factors to the actual pay of state employees.

Thus an equation was derived that best explained the relationship between factor ratings from the job evaluation and the actual pay of the thousands of jobs under study. This equation was then used to study the "fairness" of the Florida pay system with the assumption that regardless of the job family under study, the application of the predictive equation using the particular factor ratings for any family would result in a prediction that approximated the actual pay for every job family. As is typical, however, that is not what was found. When the equation derived across all job families was used to predict the "female-dominated" job salary ("dominated" means over 70 percent of the occupants of the family are female), the predicted salary of the female-dominated job families was significantly higher than their actual salaries. The reverse effect was found for the male-dominated jobs such that their predicted salaries were significantly lower than their actual salaries. A study reporting these findings was presented to the Florida legislature for its action. Unlike other states that have implemented pay equity policies, the legislature took no action.

The Wage Gap

At the Wage Equity Day festivities in 2011, several speakers made reference to the "wage gap" between men and women. Despite over 40 years of the Equal Pay Act, the National Committee on Pay Equity reported in June 2011 that women earned 78 cents for every dollar earned by men, African American women earned 72 cents on the dollar, and Hispanic women earned 59 cents per male dollar. Says Connecticut Congresswoman Rosa DeLauro, one of the co-authors of the **Paycheck Fairness Act,** "No matter how hard women work or whatever they achieve in terms of advancement in their own profession and degree, they will not be compensated equitably." But one book by a compensation expert disputes the arguments attributing the wage gap to discrimination. Says Warren Farrell, author of *Why Men Earn More,* the wage gap exists primarily because of the type of work women choose and the number of hours worked.[52]

Farrell compared the starting salaries of men and women with bachelor's degrees in 26 categories of employment, from investment bankers to dieticians. Women are paid equally in one category; in every other category, their starting salaries exceed men's. A female investment banker's starting salary is 116 percent of a man's. A female dietician's is 130 percent, that is, $23,160 compared to $17,680.

Another argument Farrell makes is that women often prefer jobs with shorter and more flexible hours in order to accommodate family responsibilities. For example, women generally favor jobs that involve good social skills and no travel. These jobs generally pay less. Another reason men earn more is that they work more hours per week. According to the Bureau of Labor Statistics, full-time men work about 45 hours a week versus 42 for women. Women choose to avoid particularly dangerous jobs that pay well. Over 92 percent of occupational deaths are men. Of course, women have a legal right to enter dangerous professions, the most dangerous of which are over 95 percent male.

Other Compliance Issues

As indicated earlier, many states and local governments have their own regulations that cover workers in addition to the federal legislation. Human resource professionals must stay educated on these matters and be prepared to ensure that their organization complies with such laws. Often legislation covers areas with which business management would rather not concern itself. Such issues as maintaining records that document compliance with the overtime provisions of the FLSA or documenting the basis for a particular position's exemption from coverage under the overtime provisions of FLSA are not issues that are foremost in the minds of most CEOs. However, the cost of noncompliance can be extremely high and can include back pay awards, penalties, plus interest. One technique that has been recommended to assist HR professionals in ensuring that their policies and practices are both effective and nondiscriminatory is the **HR audit.** HR audits can be comprehensive or specifically focused. Four audit types have been identified. Compliance audits examine the degree to which the company is observing current federal, state, and local regulations. This includes ensuring that required documentation is maintained and/or posted. Best practices audits compare current practices with those of companies identified as having exceptional practices. Strategic HR audits examine the degree to which strengths and weaknesses are aligned with the company's strategic goals. A function-specific HR audit examines key activity areas within the HR function (e.g., performance management, internal job opportunities, etc.).[53]

In this section, we have examined the general methods and processes used by organizations to establish pay programs. We discussed the traditional approach, which may still be very effective in some organizations, and noted some recent trends. In addition, we briefly looked at the way the government involves itself in pay issues. In the next section, the emphasis is shifted away from wage and salary payments to the area of employee benefits.

FRINGE COMPENSATION: EMPLOYEE BENEFITS

Employee benefits focus on maintaining (or improving) the quality of life for employees and providing a level of protection and financial security for workers and for their family members. Today organizations offer benefits for three reasons. First, benefit programs are used to attract, retain, and motivate high-performance employees in the same way that cash compensation is used. Second, employers are usually able to buy benefits for its workforce at lower costs than the employees are able to buy them for themselves. This is because per-participant insurance costs tend to decline as the size of the covered group gets larger. In very large groups, the risk of high costs because of a few participants who both need and will use the benefits is spread across more participants who will, most likely, not need or use the benefits as much. Costs also decline as groups get larger because the plan's fixed administrative costs can be spread (or shared) across a larger number of participants. The third reason that companies offer benefits is that, in the United States, employee benefits receive very favorable tax treatment.[54]

Research supports the importance of the benefits package in applicants' job selection process. In one study, conducted by the Employee Benefits Research Institute (EBRI), 77 percent of workers said that the benefits offered by a prospective employer were "very important" in their decision to accept or reject the job.[55] Other research shows that women are particularly attracted to a company with a flexible and strong pro-family benefit package. However, employees tend to underestimate the cost of benefits to the organization. For example, one study found that current employees estimated the cost of benefits to the organization as 12 percent of payroll when the actual cost was 31 percent.[56] In addition, if employees do not frequently use their benefits, they become unaware of the coverages that are provided within the plan. In one study, employees could describe fewer than 15 percent of the features of their benefits package.[57] Organizations are now working harder to better explain the cost of the benefit package to employees.

Employees underestimate the cost of benefits

In addition to the health care and pension challenges raised at the beginning of this chapter, there are three other noteworthy trends in benefits.[58] First, over the past several decades, the popularity of employee benefits has increased significantly. In 1929, benefits offered to employees averaged 3 percent of payroll; by 1950, the figure had risen to 16 percent; by 2010, the cost of benefits was about 29.2 percent of payroll.[59] Second, while benefit plans historically were quite uniform across companies, today there is considerable variation in the type of benefits offered. The third trend is the increased flexibility employees have these days in selecting their own benefit coverages.

Great differences in benefit programs

Benefit programs vary as a consequence of the organization's human resource philosophy, its size, its location, the type of business, the industry, and the type of job that an individual holds.[60] Some companies such as Stride Rite, Johnson Wax, Procter and Gamble, and Merck have a strong pro-family orientation to their benefit package with options such as family care leave, child and elder care support, dependent care accounts, adoption benefits, alternative work schedules, and on-site day care. In general, larger companies offer a wider array of benefits.[61] Across large, medium, and small organizations, benefit programs for professional and technical employees tend to be the most comprehensive, followed by those for clerical and sales employees, and then for blue-collar and service employees.[62]

As indicated earlier, employee benefits enjoy special tax treatment in the United States. There are three general types of tax advantages, provided that the plans comply with certain rules. First, employers are allowed **tax deductions** for the costs of benefit programs. In this way, the cost of benefits is treated in the same way as direct payroll costs. Second, employees receive many benefit plans, as well as some plan payouts, on a **tax-free** basis. For example, when an employer offers a health care plan, three things typically occur: (1) the organization deducts the cost of the plan from its earnings for tax purposes;

(2) employees are not taxed on the cost of the plan that the employer has provided to them; (3) employees are not taxed on the reimbursement they receive under the terms of the plan for covered services. Particularly when individual tax rates are rising significantly, these tax advantages make employee benefit programs attractive alternatives to direct pay for many employees. The third tax advantage is that some benefits are **tax deferred.** For example, when an employer sets aside retirement money for an individual, taxes are not paid on that money (or the investment earnings on the money) until the money is actually withdrawn by the employee, presumably during retirement. Similarly, when an employee makes certain types of contributions to a company 401(k) program, those contributions are typically made on a pretax basis. Employer contributions are not taxable for the individual, nor is any interest accumulation taxable until the employee begins actually withdrawing the money. Liberal loan provisions and rollover options permit the delay of taxes even longer. Thus favorable tax treatment has made employee benefits a worthwhile investment both for organizations and for individual workers.

Flexible benefits

A growing number of U.S. companies now offer flexible, or cafeteria-style, benefit plans.[63] With the increasing diversity of the workforce, cafeteria plans are particularly valued by the two-income family because duplicate coverage can be replaced with other valuable benefits, such as increased time off or child care allowances. Cafeteria plans are not new. Decades ago, organizations were reluctant to implement them for two reasons: (1) the increased administrative complexity created by managing a large variety of possible benefit combinations across an entire workforce and (2) the concern that benefit costs might rise dramatically when employees are allowed to opt out of coverages that they would be unlikely to use and replace those programs with benefits that they might use extensively. Over the past decade, however, the increased sophistication in user-friendly computer software and consulting firms that have built considerable track records assisting companies with these plans have supported the rapid growth of cafeteria plans, and this growth is expected to continue for the foreseeable future. There is some evidence that the installation of a flexible benefits plan creates positive employee reaction, including higher benefits satisfaction, overall job satisfaction, pay satisfaction, and improved understanding of the benefits program.[64]

Categories of Employee Benefits

As we said earlier, fringe benefits may be divided into legally required programs and discretionary benefits. Discretionary benefits include (1) employee welfare programs; (2) long-term capital accumulation programs; (3) time-off plans; and (4) employee services.

Legally Required Programs

Figure 10-12 summarizes the principal provisions concerning legally required benefits. In 2010, the cost of providing legally required benefits represented 8.2 percent of total compensation costs.[65] Five benefits programs are required by federal law. Social Security, unemployment insurance, and workers' compensation are basic income continuity programs. In

Figure 10-12 **Summary of Federal Laws Affecting Legally Required Benefits**

Law	Provisions
Social Security Act of 1935	Requires that companies cover employees under comprehensive program of retirement, survivor, disability, and health benefits (OASDHI).
Federal Unemployment Tax Act (FUTA)	Requires that employers pay taxes to cover laid-off employees for up to 26 weeks (additional extensions possible).
Workers' Compensation Laws	Requires that employers finance variety of benefits (i.e., lost wages, medical benefits, survivor benefits, and rehabilitation services) for employees with work-related illnesses or injuries on "no-fault" basis.
Consolidated Omnibus Budget Reconciliation Act (COBRA)	Requires employers to provide access to health care coverage in particular instances when coverage would otherwise be terminated. Cost of coverage may be completely passed on to worker. Administrative record-keeping fee also may be charged.
Family and Medical Leave Act of 1993 (FMLA)	Requires employers to continue providing health care coverage to employees who are on FMLA leave (up to 12 weeks per year for specified family emergencies) on same basis as it was provided before the leave.

other words, they provide payments when an individual is not working. The **Consolidated Omnibus Budget Reconciliation Act (COBRA)** and the **Family and Medical Leave Act (FMLA)** focus primarily on employees' right to maintain their health care benefits. The FMLA allows workers to take job-protected, unpaid time off to care for themselves or a family member.

Social security

Social Security: Under the Social Security program, eligible individuals are covered by a comprehensive program of retirement, survivor, disability, and health benefits. Individuals are eligible for Social Security retirement benefits in the form of monthly payments when they reach the stipulated age under the program, and provided they have worked long enough to qualify for benefits.

Disability

Disability Social Security benefits are comparable to retirement benefits and are provided only when a disability is expected to endure for at least 1 year or is expected to result in death. In addition, individuals must be disabled for 6 months before they qualify for payments. Survivor benefits may be available to a worker's beneficiaries, depending on his or her length (and recency) of employment.

Medicare

The Medicare program provides health care benefits to nearly all United States citizens aged 65 or older regardless of whether or not they have worked. Medicare is also available to individuals receiving Social Security disability benefits after a specified period. Medicare Part A covers hospital costs. Part B is a voluntary and contributory supplement covering medical expenses. Part C (passed in 1997) provides new health care coverage options to Medicare recipients, including managed care plans, medical savings accounts, and Medigap protection to fill the unpaid gaps in Medicare Parts A and B. Medicare Part D (passed in 2003; implemented in 2006) covers some prescription drug costs.

Employers and employees share equally the cost of providing Social Security coverage to individuals. The tax paid by employers and employees is based on the Federal Insurance Contributions Act (FICA). The 7.65% tax rate paid by both employees and employers is the combined rate for Social Security and Medicare. The Social Security portion (OASDI) is 6.2% on earnings up to the applicable taxable maximum amount ($110,100 as of January, 2012). The Medicare portion is 1.45% on all earnings. Readers should consult www.ssa.gov for current tax rates as temporary tax cuts were in place in 2012.

When the program was established in 1938, there were 39 workers for each retiree. In 1950, there were 16 workers paying in for each retiree. Today, there are about 2.8 workers for each Social Security beneficiary. Unless major action is taken and soon, there is big fiscal trouble ahead for the federal government. Social Security, Medicare, Medicaid, and the Children's Health Insurance Program (CHIP) represented 41 percent of federal expenditures in 2010. Assuming no major changes to these programs, it is estimated that by 2037 the three programs will run out of money, thus being financed only by the income from Social Security taxes. It is projected that this income will provide 78 percent of the benefits promised. In late 2010, The National Commission on Fiscal Responsibility and Reform provided recommendations aimed at salvaging the Social Security and Medicare programs, including increasing the Social Security tax, raising the retirement age, and/or reducing benefits. While the recommendations continue to be discussed, Congress has taken no specific action at the time of this writing.[66]

Unemployment insurance

Unemployment Insurance: The unemployment insurance program in the United States is jointly managed by the federal government and the states. The program is designed to encourage employers to stabilize their workforces, and it provides emergency income for workers when they are unemployed.[67] The federal unemployment tax is 6.2 percent on the first $7,000 of wages. However, in the majority of states, an employer's tax rate (and/or the wage base) is higher than this federal guideline and is based on general pay trends and unemployment rates in the state. In Florida, for example, where the statewide unemployment rate hovered at 11 percent through much of 2009, sufficient funds to finance promised benefits were not available. In fact, a $1.3 billion surplus in the state's unemployment benefit account was wiped out between mid-2008 and mid-2009 due to a surge in the number of people being put out of work there. By late 2009, Florida was borrowing $300 million per month from the federal government in order to continue paying unemployment benefits to those who met eligibility requirements. This borrowing triggered an automatic increase in unemployment taxes paid by business organizations in the state. For the average employer, the cost to cover its workforce under the unemployment program (a federally required coverage) jumped from $8.40 to $100.30 per employee. This is a huge increase, particularly at a time when so many businesses are struggling to survive.[68]

Most states allocate unemployment taxes to individual organizations using an "experience rating" approach, which imposes higher tax rates on companies that create the unemployment.

In terms of payouts under the unemployment program, the individual states decide how much to pay, how long to pay, and on what basis they will pay. In general, employees who are covered under FUTA (the Federal Unemployment Tax Act), and whose employment is terminated, are eligible to receive unemployment payments for up to 26 weeks. A 1970 amendment permitted an extension of these benefits, usually for an additional 13 weeks. Such Supplemental Unemployment Benefits (SUBs) are usually triggered when a state's unemployment rate exceeds a particular level. Since late 2001, when the economy first weakened, additional 13-week extensions have been approved, permitting unemployment recipients up to 65 weeks of benefits. Such extensions were in effect in 2010. To be eligible to receive benefits in general, a worker must have been employed previously in an occupation covered by the insurance, must have been dismissed by the organization (but not for misconduct), must be actively seeking work, and (in all states but Rhode Island and New York) may not be unemployed due to a labor dispute.

Workers' compensation

Workers' Compensation Insurance: Unlike unemployment compensation insurance, workers' compensation (WC) programs are managed solely by the states with no direct federal involvement or mandatory standards. Typically, workers' compensation provides for medical expenses and pay due to lost work time in cases where the illness or injury is work related. The primary purpose of workers' compensation programs is to provide for benefits to injured or ill workers on a no-fault basis and thus to eliminate the costly lawsuits that would otherwise clog the legal system and disrupt employer–employee relations.[69]

The first laws for handling occupational disabilities and death were enacted in 1910, and they have existed in all states since 1948. Employers are fully responsible for the cost of the coverage, and they may not require any employee contributions. To facilitate the consideration of claims, most states have established workers' compensation boards or commissions. In most states, employers are free to select their own carriers to insure the risk (or to self-insure the risk), investigate claims, and process payments. More will be said about workers' compensation programs in Chapter 14.

COBRA

Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA): This law was enacted in order to provide current and former employees, and their eligible dependents, with a temporary extension of employer-provided group health insurance when coverage would otherwise be lost. When it is the employee whose coverage is lost (e.g., layoff or other form of termination), the individual has the right to continue medical coverage for up to 18 months. When a dependent's coverage is lost (e.g., due to the death of the worker, divorce, or reaching the maximum age for a dependent child), the covered individual is entitled to continue the coverage for a maximum of 36 months. In all cases, the individual pays the full cost of the coverage and organizations have the option of adding a 2 percent surcharge to cover administrative costs.

As the cost of health care coverage skyrocketed, however, increasing numbers of individuals found that they were unable to afford to continue their health care coverage under COBRA when they lost their job. Families USA reports that the average monthly health care premium for family coverage (in South Florida, for example) is $1,037, which is more than the state's average monthly unemployment benefit of $1,013. As part of the economic stimulus package, and to prevent a spike in the number of Americans without health care protection, the federal government agreed to pay 65 percent of the COBRA premium, beginning in February 2009, for up to 9 months. In December 2009, the subsidy period was lengthened to 15 months. The COBRA subsidy program expired at the end of May 2010, although workers who had lost their jobs and were enrolled in the program before that date were allowed to keep their subsidy for the full 15 months.

There is a question about the effectiveness of the COBRA subsidy program. The Employee Benefits Research Institute (EBRI) indicated that the subsidy helped far fewer people than expected, mostly because, even with the subsidy, the cost of health care benefits for unemployed individuals was just too high. However, several major consulting firms (Hewitt, Aon, Ceridian) have taken issue with this assessment, pointing to the results of their own studies and surveys that indicate that the subsidy was "on target" and helped at least as many as expected of the unemployed hold onto their health care coverage.[70]

FMLA

Family and Medical Leave Act of 1993 (FMLA): FMLA entitles all eligible employees to receive unpaid leave for up to 12 weeks per year for specified family and medical emergencies relating to self, spouse, parents, and children. When the employee returns to work, the act requires the employer to place the individual in the same or an equivalent job, with the same pay, benefits, and conditions of employment. During the leave, the employer is required to continue to provide coverage under the health care program on the same basis as it was provided before the leave. In other words, if the cost of the insurance was shared between the employer and employee, the employer can continue to require such cost contributions. If an employee on a leave fails to live up to his or her financial obligations to the plan (e.g., payment within 30 days), the employer may drop the employee after giving at least 15 days' notice. Supervisors may have personal liability for violations of the FMLA.

In 2008, FMLA was revised to provide up to 26 weeks of leave per 12-month period to an eligible employee who is the spouse, son, daughter, parent, or next of kin to care for a wounded member of the U.S. Armed Forces (the latter term in this revision specifically includes National Guard and Reserves). The 2008 revision also provided up to 12 weeks of leave to an eligible employee to respond to urgent needs relating to a family member's call to active service. New Jersey recently became the third state (with California and Washington) to provide paid family leave for workers to care for newborns, newly adopted children, or seriously ill family members. According to the Department of Labor, almost 17 percent of U.S. workers reported having used the FMLA. In this same report, the great majority of employers reported that FMLA involved no cost to them, or only small costs.[71]

Discretionary Plans: Employee Welfare Programs

The benefits of greatest concern to both employees and employers in this category are health care plans. Also included in this category are survivor benefits (life insurance) and short- and long-term disability plans.

Health care

Health Care Plans: In a survey of more than 1,600 employees in large companies, more than 80 percent said they valued their health benefits above anything else in their compensation package, including salary.[72] In March 2010, the Patient Protection and Affordable Care Act (PPACA) was passed by Congress and signed into law by the president.[73] This law has been described as a "once in a generation overhaul of about one-sixth of the United States economy." At the time of its passage, an estimated 59 percent of the U.S. population received their health care coverage through their employer. Ninety-six percent of employers with 50 or more employees offered such coverage. While there is widespread disagreement about how health care should be changed, there is little argument about the underlying problems that warrant addressing. First, there is a consensus about the need to improve both access to and the quality of health care. The U.S. Census Bureau reported that 15 percent of the population (or 46.3 million people) did not have health care coverage in 2008. During 2007 and 2008, an estimated 28 percent of the population was without coverage at some point. Young adults represent approximately 33 percent of the uninsured population. Second, escalating health care costs need to be reined in. Premiums for health care coverage have more than doubled over the last decade, which is triple the rate of wage growth over the same period. Third, financing the reform is critical. See Figure 10-13 for the highlights of health care reform. The major market reforms will become effective in 2014. These include the establishment of health care Exchanges, implementation of major market reforms applicable to those who issue health care insurance, and the mandates concerning who must provide health care coverage ("pay-or-play" provisions) and who must be covered ("enroll-or-pay" provisions). At the time of this writing, Congress (elected in 2010) indicates that it will repeal the act and/or significantly alter its provisions. Primary complaints include that the program is too "large," the federal government has too central

Figure 10-13 **Highlights of Patient Protection and Affordable Care Act (PPACA) of 2010 (signed into law, March 23, 2010)[a]**

TRANSITION PERIOD PROVISIONS—GROUP HEALTH PLANS AND HEALTH INSURANCE (2010–2013)

- Elimination of lifetime limits and begin phasing out annual limits on health care benefits
- Elimination of pre-existing condition exclusions for participants under age 19
- Preventive health care services must be offered at no cost to plan participants*
- Extension of coverage for children until age 26
- Establishment of appeals process which meets federal guidelines concerning plan participation and claims disputes*
- Restrictions on terminating participant coverage, other than for fraud or misrepresentation
- Federal government will establish rules relating to health care plan, providers, and insurers to improve quality and transparency of health care, and to control health care costs. Plan issuers will submit annual compliance reports*
- Insured plans must spend at least 85% (large employers) or 80% (small employers) of premium revenues on medical claims, or rebate a portion of the excess
- Tax credits implemented for small business (<25 employees) to help provide health care programs
- Begin implementation of new incentives to expand number of primary care physicians, nurses, physician assistants

PPACA COVERAGE EFFECTIVE JANUARY 1, 2014

- **Individual and small employers (<100 employees) may purchase health care coverage through Exchanges**
  - An Exchange is a marketplace of health insurance issuers, including not-for-profit insurance companies and non-profit cooperatives
  - Individual states will establish the Exchanges using $6 billion in federal grant money
  - Exchange must offer health care that meets federal criteria relating to benefits, costs, and provider characteristics (designated as "Qualified Health Plans" or QHPs). States may stipulate additional criteria and benefits
  - Beginning in 2016, states may define small employers as those with fewer than 50 employees
  - Large employers are not permitted to purchase a QHP through Exchanges until 2017 at the earliest
- **Effective date for market reforms applicable to insurance issuers**
  - Elimination of preexisting condition exclusions for adults (i.e., >age 19)
  - Elimination of annual limits on health care benefits
  - Premium variations limited only to a) individual vs. family coverage; b) geographic rating area (established by states); c) permissible age bands established by HHS (with limitations); d) tobacco use (with limitations)*
  - All plans must guarantee coverage availability and renewability*
  - Elimination of benefits discrimination based on health care status
  - Limits placed on participant cost-sharing amounts*
  - Participant waiting periods for coverage may not exceed 90 days
  - Coverage must include medical services provided in approved clinical study trials
- **"Enroll-or-pay" requirements implemented**
  - All American citizens must obtain health care coverage or pay a tax penalty (some exceptions apply)
- **"Pay-or-play" requirements implemented for large employers (50+ employees)**
  - Two penalty types . . .
    - Large employees who choose not to offer health care protection
    - Employers who provide "minimum essential" coverage that is "inadequate" or "unaffordable" (definitions provided)
- **Increases to small business health insurance tax credits**

[a]Certain collectively bargained plans may be subject to special rules and/or effective dates.
*"Grandfathered" plans are excluded from these requirements. Grandfathered plans are group health plans that existed on March 23, 2010, and that meet (and continue to meet) stipulated requirements for benefits offered and participant costs. Grandfathered plans fulfill congressional and presidential promise, "If you like your current insurance, you will keep your current insurance."

a regulatory role, and the act's provisions should rely more on market-based mechanisms. Experts indicate that, while they do not foresee its repeal, changes should be expected. Several states have filed lawsuits, particularly arguing that the "enroll-or-pay" provision that requires all American citizens to obtain health care coverage (some exceptions apply) violates Article I of the U.S. Constitution and the Tenth Amendment. In June, 2012, the Supreme Court ruled on the constitutionality of the requirement to either purchase health insurance or pay a fine.

In 2010, 86 percent of workers had access to employer-provided health care benefits, and 59 percent of workers actually participated in such plans. On average, employers paid 80 percent of the cost of premiums for single coverage, and 70 percent of the cost for family coverage.[74] The Employee Health Benefits survey conducted by the Kaiser Family Foundation reported that 30 percent of employers reduced health benefits and/or increased the employee cost-sharing percentage in 2010. "The Kaiser Family Foundation CEO said it was the first time he could remember employers moving so boldly to shift health care costs to workers."[75] In 2010, individual health care coverage costs rose by 5 percent, but actual contributions required of individual participants rose 15 percent, from $799 to $899 per year. Employer costs for individual participants rose from $4,045 to $4,150 per year. For family coverage, health care premiums in 2010 rose by 3 percent with employees absorbing the full cost of the increase. In 2010, family coverage cost employees an average $3,997 per year (an 11.4 percent increase) with employer contributions for family coverage remaining flat at $9,800 per year. In 2010, 27 percent of workers were covered under health care plans with annual deductibles of at least $1,000. In small firms (less than 200 workers), 46 percent reported deductibles of at least $1,000.[76] A disturbing contemporary trend is the dropping of health care benefits for workers and retirees. Can an employer drop health care benefits for workers who are under the age of 50 while maintaining them for retirees? The Supreme Court recently ruled in *General Dynamics Land Systems v. Cline* that the Age Discrimination in Employment Act does not prohibit an employer from practicing "reverse age discrimination" where older workers are favored over younger workers who are over 39.

Trend: Dropping health benefits

Health Care Management Tools: Four other health care management tools are increasingly popular: (1) wellness programs, (2) personal responsibility clauses, (3) periodic health care plan audits, and (4) managed care plans. **Wellness programs** are typically used in two ways: (1) to educate employees to make informed decisions about their lifestyles and their health care and (2) to challenge employees' belief that employers are responsible for their health and for paying all their medical care costs. One survey found that 76 percent of responding organizations had wellness plans in place. One study tracked health care expenses of employees enrolled in wellness programs versus employees of similar health risk who were not participating in wellness programs (2001–2005) and reported that, for every wellness dollar spent, the company saved $1.65. Based on multiple studies and trends, organizations can expect to save $1.50 to $3.00 for every dollar spent on wellness programs after they have been in effect for 3 to 5 years. The 2010 Health Care Reform Act provides that employers can offer higher incentives to employees who participate in wellness programs than are currently allowed.[77] Wellness programs are discussed further in Chapter 14.

Wellness programs save money

Personal responsibility clauses are based on the principle that if employees or their dependents take personal risks, then they should bear additional responsibility for the costs arising from resulting illness or injury. The two most targeted behaviors for plan incentive or disincentive strategies are smoking and seat belt use, but other activities (e.g., extreme sports) may also apply.

Health care plan audits focus on carefully tracking plan utilization and costs in order to determine whether the organization's health care spending is generally effective.[78] Audits include examining claims to ensure that benefits are paid accurately and within acceptable time frames, conducting employee surveys about health care and lifestyle issues, tracking which providers are widely used (for the purpose of possibly negotiating volume discounts), and making certain that when more than one insurance plan is in effect (e.g., coverage under a spouse's plan), benefit payments are correctly coordinated.

Managed care continues to grow. Popular approaches include **health maintenance organizations (HMOs), preferred provider organizations (PPOs), and point-of-service (POS) plans.** HMOs are organizations comprised of health care professionals who provide services on a prepaid basis. PPOs are usually hospitals and health care professionals that offer reduced rates based on a contractual arrangement with the organization. Point-of-service plans are an HMO-PPO hybrid that permits out-of-network medical consultation and treatment (some plans do not require authorization by the primary care physician) in exchange for higher patient deductibles and co-payments for those transactions.

ERISA

Government Regulation of Health Care Programs: Earlier in this chapter, we described the Fair Labor Standards Act (1938), which regulates cash compensation (minimum wage, overtime pay, child labor laws). The **Employee Retirement Income Security Act of 1974 (ERISA)** makes rules relating to employee benefits. It was passed because many retiring workers were not getting the benefits that had been promised to them over their working lifetimes.[79] Earlier in this chapter, we described the tax advantages enjoyed by company-sponsored benefit plans. In order to qualify for this favorable treatment, however, an employee benefit plan must be "qualified"; that is, the plan must be in full compliance with all provisions of ERISA.

Under ERISA, health care plans must be set forth in written documents that clearly describe the terms of the plan, eligibility requirements for coverage under the plan, and how it is funded. Employees are entitled to detailed information concerning their health care plan and the state of its financing. Each year, organizations are required to submit annual reports concerning the state of the plan and to send a summary of the annual report to all plan participants. ERISA requires notification to participants when substantive changes are implemented and advance notification if the company intends to terminate the plan.

HIPAA

In 1996, ERISA was revised to include the **Health Insurance Portability and Accountability Act (HIPAA).** This act, which applies to all employers offering group health plans, significantly reduced an employer's ability to deny or limit coverage for preexisting conditions, or to require higher premiums based on an individual's medical condition. Effective in 2003, health care privacy rules were implemented that require health care entities (plans, providers, etc.) to obtain a patient's written consent before releasing any health care information. In order to obtain consent, the act requires full disclosure about how and for what purpose such medical information will be used. Historically, health care plan design features were not subject to the same level of control and regulation by ERISA, as it exercised over pension plan design (discussed later in this chapter).

MHPAEA

The Mental Health Parity and Addiction Equity Act (MHPAEA) was passed in 2009. The law requires that any organization with 50 or more employees, whose group health plan covers mental health and substance abuse along with standard medical and surgical coverage, must treat them equally in terms of out-of-pocket costs, benefit limits, and related administrative practices (e.g., prior authorization, utilization review).

Under the **Age Discrimination in Employment Act (ADEA),** employer health plans must offer the same benefits to employees aged 65 and older (and their spouses, if applicable) as the plan provides to younger employees. (Traditionally, organizations moved employees at age 65 onto Medicare and provided a Medicare Supplement policy. This practice is no longer permissible.) The **Pregnancy Discrimination Act of 1978** requires that pregnancy and pregnancy-related disabilities be treated the same as other illnesses or disabilities. Employers who offer health care plans, temporary disability plans, and sick leave are now legally required to include pregnancy as a covered condition. As mentioned earlier, both **COBRA** and **FMLA** are primarily aimed at preserving health care benefits for individuals.

Life Insurance: One of the oldest and most common forms of employee benefit is group life insurance. In 2010, 73 percent of full-time workers in the United States were covered under company-provided life insurance programs at an average cost to employers of $83.20 per covered employee annually.[80] Most of those programs based benefits on a fixed multiple of earnings. The most common multiple is 1.0 times earnings (61 percent of plans), followed by 2.0 times earnings (22 percent of plans).[81] Group life insurance typically provides coverage to all employees of an organization without physical examinations, with premiums typically based on the group characteristics.[82]

Discretionary Plans: Retirement Plans

Retirement plans provide payouts to retired employees based on the extent and level of employment with the organization. In 2010, 74 percent of full-time workers in the private sector were employed in companies that offered retirement plans. Fifty-nine percent actually participated in such plans.[83] Retirement plans include not only traditional pensions, but also 401(k) programs, thrift and other savings programs, traditional profit-sharing plans, and a large variety of similar arrangements.

The term **long-term capital accumulation plan** is the generic name for any program that seeks to systematically set aside money during one's working lifetime, primarily for use during one's retirement.

The Major Retirement Plans: There are two types of retirement plans: **defined benefit plans** and **defined contribution plans.** A defined benefit (DB) plan, which is the traditional pension in the United States, guarantees a specific retirement payment based on a percentage of preretirement income. Typically, the amount is based on years of service,

Defined benefit plans

average earnings during a specified time (e.g., last 5 years), and age at time of retirement. The typical target benefit in a defined benefit plan is to replace approximately 50 percent of an individual's final average pay.[84] Some defined benefit plans (approximately 5 percent) are indexed to adjust pensions for inflation.[85] In a defined benefit plan, the employer funds employees' pensions over their working lifetimes. An employer's commitment to an employee is for a particular payout, at a particular time, based on a formula specified by the plan. DB programs typically involve significant administrative fees, particularly for actuarial services, to ensure that the plan is financed appropriately under ERISA requirements. In addition, DB plans are required to purchase insurance with the Pension Benefit Guaranty Corporation (PBGC), which acts like the FDIC by insuring pension monies in the event that the company goes bankrupt (or is otherwise unable to meet its promised obligation). In 2011, it was estimated that the PBGC insured an estimated 27,500 corporate defined benefit plans covering 44 million U.S. workers.

In 2005, United Airlines, under bankruptcy protection, was granted permission to terminate its employee defined benefit retirement plans that would have obligated United to pay $3.2 billion in pension payouts over the next 5 years. The **Pension Benefit Guaranty Corporation** assumed responsibility for the 134,000 people who were part of the United plans. The result of the takeover significantly lowered pension checks for United retirees and created long-term PBGC obligations totaling around $10 billion. Experts worry that other companies will opt to dump their pension obligations on the already deeply indebted PGBC. As of September 30, 2010, corporate defined benefit pension plans had a collective funding deficit of $21.6 billion. Specifically, the plans had promised more than $121 billion in benefits but only had assets to pay out $99.4 billion.[86]

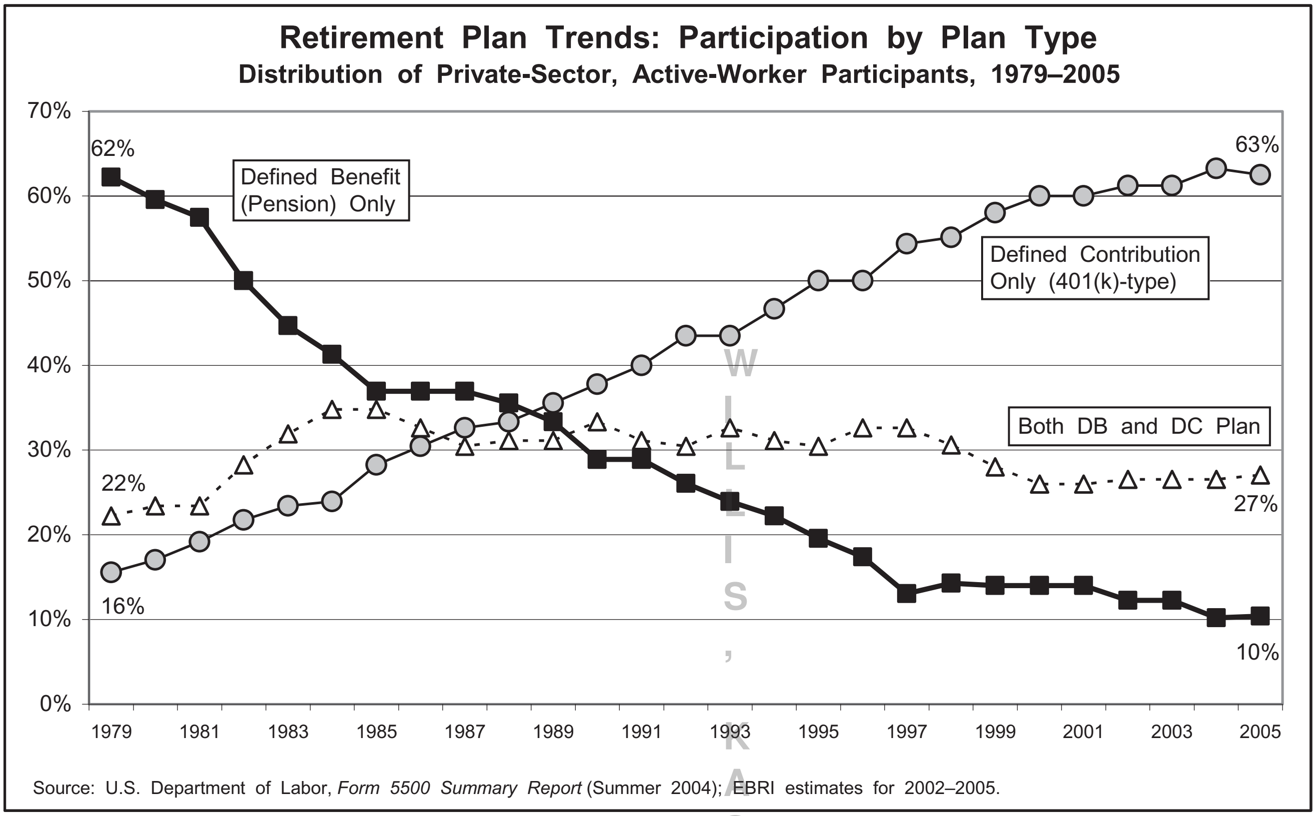
Two things happened during this recent economic slump to further weaken the system. First, more companies failed and turned over their pension liabilities to the PBGC. In 2009 alone, the agency became responsible for another 200,000 workers. Second, low returns on investments have increased the gap between the promises made in the plans and the value of the funds set aside to cover the promises.[87] Even before the recession (2005–2008), many large companies had cut their pensions, according to Watson Wyatt Worldwide, a compensation consulting firm. Eleven percent of these firms either discontinued their pension plans altogether or froze benefits to workers. It is estimated that DB plans fell about $500 billion into arrears in 2008. How did this happen? Companies lobbied for and received lax regulations on how to calculate pension obligations, estimating returns on pension investments twice as high as they actually returned. Companies do this so they can use more revenue to report as earnings. They, of course, have the PBGC to fall back on to bail them out if they cannot meet real pension obligations. The PBGC (which has been running a deficit since 2002), relies on risk-based premium payments funded annually by defined benefit pension plans. But, the PBGC doesn't have the authority to raise its premiums. That responsibility rests with Congress. While President Obama has proposed giving the PBGC that authority (which is the way the FDIC operates), this change has mustered strong opposition to date by the powerful Chamber of Commerce business lobby.[88] Many state and local governments are facing similar (or worse) shortfalls in benefits promised versus benefits currently funded. In many states, movements to reduce promised defined benefit plans and/or increase employee contributions are gaining traction.[89]

Defined contribution plans

In a **defined contribution (DC)** plan, an employer provides a specific dollar amount (typically a percent of base salary) that is paid into an individual's account each period. The most common DC plan is the 401(k) plan, which is named after the section of the Internal Revenue Code that regulates these plans. In a typical 401(k) plan, employees defer a percent of pay (subject to certain limitations) that is fully or partially matched by the company. Employees choose among investment options and, typically, may take the vested portion of the account with them if they leave employment before they are eligible to retire (vesting refers to the point in time when pension monies set aside by a company become the actual property of the plan participant).

In a 401(k) plan, the employer makes no promise to an employee about a pension amount: an individual's pension is the account balance at the time of retirement. As a result, administrative costs are lower under 401(k) programs (and other DC plans) than they are under traditional DB plans, and plan communication is simplified. DB plans have

Figure 10-14 **Retirement Plan Trends**



Trend: Replacing defined benefit plans

been more common historically than DC plans, but recent concerns about cost uncertainties pushed many companies to replace their DB plans with the simpler, less expensive DC plans. IBM froze pension benefits for its American employees beginning in 2008 and shifted instead to 401(k) plans. Among the many companies that have recently frozen traditional pension plans for employees are Verizon, Hewlett-Packard, Motorola, and Sears. In the late 1980s, similar numbers of employees were covered under DB plans (35 percent) and DC plans (35 percent). By 2005, the percent of employees covered under DB plans declined to 10 percent (and 19 percent of those covered under DB plans were in frozen plans). At the same time, by 2005, the number of employees covered under DC plans had grown to 63 percent, with 41 percent of employees actually participating. The biggest barrier to DC plan participation is the employee contributions they typically require. Among the bottom 10 percent of wage earners, 27 percent were eligible for inclusion in their company's DC plan but only 8 percent did so.[90] Even so, the number of employees participating in DC plans since 1995 has more than doubled. Figure 10-14 presents the trends for the private sector.

All these changes and uncertainties have created a record number of older workers who have lost faith in their ability to afford retirement. More than 27 percent of older U.S. workers reported in early 2011 that they have "no confidence" that they will be able to afford a comfortable retirement. An additional 20 percent said that they now plan to delay their retirement. Yet, almost half of current retirees report that they retired earlier than they had planned, largely due to health problems or disability.[91]

Government Role in Pension Plans: As mentioned earlier, the **Employee Retirement Income Security Act (ERISA)** regulates employee pension plans. The requirement that defined benefit plans purchase insurance through the PBGC is an ERISA rule. Since establishment of this rule, more than 4,200 pension plans have resorted to the PBGC in order to meet their pension commitments.[92] ERISA has passed extensive rules concerning the way pension funds may be invested (in general, using a "prudent man" rule focusing on capital preservation), has broadened participation rules (people at all levels in the organization typically enter a plan after only 1 year of employment), and liberalized vesting rules (after 2 to 3 years, at least a portion of the company contribution belongs to the employee). Before ERISA, many pension plans had no vesting provisions; if you weren't working for the company the day you retired, you were not entitled to any benefit.

Other nonbenefits legislation has significantly influenced pension plan provisions. The **Civil Rights Act of 1964** and subsequent amendments, which prohibit discrimination on the basis of gender, outlawed pension differences between men and women even if such distinctions were based on real life expectancy differences. Today, most plans use unisex tables that combine the life expectancy rates of men and women. Amendments to the **Age Discrimination in Employment Act (ADEA)** indicated that the mandatory retirement of any individual over age 40 would violate ADEA. In addition, individuals who work beyond the firm's "normal" retirement age must continue to accumulate retirement credits on the same basis as any other eligible employee.

Mandatory retirement violates ADEA

Paid Time-Off Programs: The cost of paid time off represents a significant cost for employers today. In December 2010, the cost of paid time off to employers amounted to 6.8 percent of total hourly compensation, or close to $4,000 per employee annually. According to the United States Bureau of Labor Statistics (BLS), in 2010, 74 percent of full-time workers in private industry received paid sick time; 91 percent received paid vacation; and 43 percent receive paid personal leave.[93] Of course multinationals must comply with the laws of the host country for its citizens.

Connecticut became the first state to mandate paid sick leave in 2010. (Washington, DC and the city of San Francisco have such requirements.) The law covers only service workers employed by businesses with 50 or more employees and who are paid an hourly wage, including waitstaff, fast-food cooks, hair stylists, security guards, nursing home aides, and the like. The law specifically excludes manufacturers, national nonprofit organizations, day laborers, and temporary workers from coverage. Employers that meet the requirements for coverage must provide 1 hour of paid sick time for every 40 hours worked, with the number of days capped at 5 per year. Of course this is the minimum required benefit, and employers can choose to offer more.

Trend: Paid time-off banks

One recent trend in the paid time-off area is to combine an individual's vacation and sick and personal days into one paid time-off (PTO) bank. For employees, this provides greater flexibility and control over their time and promotes better time management in general. For employers, PTO banks eliminate the need to track different time-off components and should reduce disruption related to unscheduled absences. However, research supporting whether PTO banks deliver on these promises is thin. While firms report a reduction in unscheduled absences, they also report an increase in time-off utilization as previous "sick days" (under a former sick pay plan) become, in effect, additional "vacation days" (under a PTO plan). This has prompted some organizations to consider increased utilization when they convert to PTO banks by replacing the total number of vacation, sick, and personal days with a reduced number of PTO bank time off. In addition, there are also conflicting figures about how widespread PTO banks really are. The Commerce Clearing House (CCH) and the Society for Human Resource Management (SHRM) indicate that PTO banks are used by about 60 percent of organizations, while Mercer Consulting, WorldatWork, Alexander Hamilton Institute, the International Foundation of Employee Benefit Plans, and Hewitt Associates place that number at 30 to 40 percent of companies. In fact, the latter groups point to data that suggests that interest in PTO banks may be stabilizing, or even beginning to decline. Thus firms that implement PTO banks in order to remain competitive must look carefully at the degree to which their key competitors, in fact, are moving to PTO banks.[94]

Disability Plans: Long-term disability (LTD) coverage typically provides for the replacement of at least some income in the event that an individual contracts a long-term illness or sustains an injury that prevents him or her from working. In 2010, 31 percent of organizations offered disability protection to full-time workers. Nine percent of those organizations required some employee contribution to support the protection. More than 90 percent of the organizations providing disability protection calculated disability payments using a fixed percentage of the employee's earnings.[95]

Employee Services

Although there are a variety of programs, the most common employee services are education programs, employee assistance programs, employee recognition programs, and child care. We briefly discuss each of these next.

Education Programs: Organizations may provide their workers with up to $5,250 per year in tax-free education benefits. While locating detailed information about the prevalence of tuition assistance programs is difficult, it is estimated that U.S. organizations spend $10 billion each year on job-related tuition reimbursement. The Society for Human Resource Management (SHRM) reports that in 2007, among large employers (500–999 employees), the high technology sector was most likely to offer education benefits (94% of companies offer assistance), and retail organizations were least likely (50% offer assistance).[96]

Employee Assistance Programs: Employee assistance programs (EAPs) typically provide counseling, diagnosis, and treatment for substance abuse, family and marital problems, depression, and financial and other personal difficulties. EAPs are used by about 70 percent of Fortune 500 companies with about one-third of U.S. employees having access to the programs. EAPs tend to be cheaper and more effective than simple reimbursement.[97] We will discuss EAPs in more detail in Chapter 14.

Employee Recognition Programs: A growing number of organizations offer awards to employees for extended service, work-related achievements, and suggestions for improving organizational effectiveness. Awards are often in the form of gifts and travel rather than cash. Suggestion systems offer incentives to employees who submit ideas that result in greater efficiency or profitability for the company. According to IdeasAmerica (formerly the National Association of Suggestion Systems), its member organizations receive more than 250,000 employee suggestions each year.[98]

Child Care: A growing number of companies are also offering various forms of child care benefits. U.S. employers lose an estimated $4 billion annually attributable to absenteeism related to child care. One-quarter of working couples who have children enrolled in a company-sponsored day care center have walked away from other job offers because of a lack of on-site day care. Almost 90 percent of parents with access to full-service, on-site child care say that it significantly improves their ability to concentrate on their job and be productive.[99] In 2007, BLS reported that 15 percent of U.S. workers had access to employer assistance for child care, most typically as a feature in a cafeteria benefits program. A growing number of companies offer on-site centers. Dominion Bankshares in Roanoke, Virginia, reported decreased absences among its 950 employees after its on-site day care center was established.

There is a growing recognition that illness among employees' children can be costly to the company in terms of absenteeism, tardiness, and work stress. AT&T invested in sick bays through hospitals and child care centers. Roche Pharmaceuticals and Hughes Aircraft offer sick child care to employees' children through convenient medical centers. The 3M Company covers up to 78 percent of the fees for home health care for sick kids.

Communicating the Benefits Program

As we indicated earlier in the chapter, many employees have little understanding of the costs involved in a benefits program. While ERISA requires that plan and cost information be routinely distributed to benefit participants, most employees know very little about how to value such programs, particularly relative to the programs offered by others. Yet, if an organization's benefits are supposed to be a key tool for attracting and retaining competent workers, this type of understanding would seem to be of paramount importance.

Over the past decade or so, companies have focused attention on improving the information they provide to employees about their benefits. The goals in benefits communication should be to clearly explain the coverages that are available under the plan and to present the value of the benefit package to current and future employees. Today many employers provide counseling for employees to enhance their understanding of the benefits program and have stepped up their investment in benefits-related recruitment literature. One very popular tool is the **Benefits Statement,** which is a periodic report customized for and distributed to each individual employee identifying his or her coverages and providing very specific cost information on each such program. Other methods used to explain benefits include paycheck inserts, employee publications, posters, and audio/video recorded messages.

When organizations implement flexible, or cafeteria, benefits, they typically find that they must step up their investment in employee benefits education. When employees are given choices about which coverages to select and which to decline, organizations should feel comfortable that employees are making these selections based on an educated understanding of each benefit option. At Citicorp, for example, employees are exposed to software, videos, seminars, and several other teaching tools that explain their flexible benefit program. Each Citicorp employee receives a printout of benefits compared to the previous year, a computer disk, and a workbook that explains how to determine the tax and "out-of-pocket" implications of the benefit options.

INTERNATIONAL COMPENSATION

With over 100,000 U.S. companies now involved in some type of global venture, it is estimated that over 60 million workers are employed overseas by U.S. companies. Chapter 2 discusses the HR strategies that companies use to help guide an organization's expansion overseas (i.e., ethnocentric, polycentric, geocentric, regiocentric). The three types of workers are also discussed (parent-country nationals, host-country nationals, and third-country nationals). McDonald's now has over 32,000 restaurants in more than 115 countries. The vast majority of its employees are host-country nationals, and more than 80 percent of its restaurants are independently owned and operated by local men and women.[100] The Nestlé company, headquartered in Switzerland, reports that more than 98 percent of its revenues come from outside Switzerland, and over 96 percent of its employees work elsewhere.[101]

While U.S. multinational companies employ 20 percent of all American workers, recent trends indicate that those organizations have been increasing their hiring abroad while cutting back at home.[102] The issue is important for two reasons. First, for decades, large multinational organizations, with their job opportunities and above-average pay and benefits, have sustained America's middle class. Second, this new trend raises questions about the long-term effects of globalization on the U.S. economy. During the 1990s, U.S. multinationals added jobs everywhere: 4.4 million in the United States and 2.7 million abroad. Since 2000, however, U.S. multinationals have cut their U.S. workforce by 2.9 million, and increased offshore employment by 2.4 million. General Electric's CEO, Jeffrey Immelt, defends the trend, "We've globalized around markets, not cheap labor. The era of globalization around cheap labor is over. Today, we go to Brazil, we go to China, we go to India, because that's where the customers are." In 2000, 30 percent of GE's business was overseas; in 2011, 60 percent is. In 2000, 46 percent of GE employees were overseas; today, 54 percent are. Microsoft appears to be an exception to the trend. Since 2005, it has added more jobs in the United States (15,300) than abroad (13,000). An estimated 60 percent of Microsoft employees are in the United States.

Compensation in Offshore Operations

Global organizations approach pay in their offshore operations a number of different ways. At one extreme, highly centralized multinationals review and approve local pay structures, incentive plans, and pay increase budgets. At the other extreme, in the decentralized model, responsibility for pay and benefits practices is delegated to the local manager. Most multinationals fall between the extremes and establish overall pay and benefits goals, philosophy, and strategy, then permit local management to structure programs within that framework.[103] While such variation exists, traditional local practices are changing for two reasons. First, more countries are implementing pay-for-performance programs, even in places where pay has been historically based on seniority (e.g., Japan) and cost of living increases (e.g., Latin America). Second, in general, the U.S. pay approach has had a significant effect globally, especially the use of job evaluation, incentive systems, and equity-based programs, particularly stock options and stock awards. From a process perspective, local pay plans are developed much as they are in the United States (described earlier in this chapter) by assessing job content and design, reviewing marketplace pay trends, and establishing a structure. In many less-developed countries, survey data about pay practices may be difficult to obtain, particularly industry-based data. However, there is a trend toward the use of "club surveys" in which companies work with others in their industry to conduct a survey, either collecting it themselves or contracting with a third party to do it. Of course in extremely large countries (i.e., China and Russia), there will be considerable use of regional pay differentials, which will involve different pay structures (and, sometimes, practices) for rural versus urban areas, where the cost of living can vary widely.

In the area of employee benefits, local company health care programs will differ based on the type and level of health care provided by the government, and legislation concerning whether supplementary health protection is required or permitted. Similarly, retirement programs will be most heavily influenced by government social security programs. The favorable tax treatment of employee benefits that characterizes U.S. benefits programs (discussed earlier in this chapter) is not the norm elsewhere.[104]

Compensation for Offshore Managers and Key Professionals

To fully realize their growth potential, U.S. companies must staff their international operations with personnel who are technically competent, culturally proficient, and cost effective. As organizations become more proficient in effectively managing global overseas operations, two trends are emerging. First, there is a growing recognition that managing global operations involves a particular skill set that differs from traditional managerial technology. According to management guru Rosabeth Moss Kanter, global management skills are becoming a major core competence for future business leaders. Such leaders will be globally skilled as (1) integrators, who will see beyond obvious country and cultural differences; (2) diplomats, who can resolve conflicts and influence locals to accept world standards or commonalities; and (3) cross-fertilizers, who recognize the best from various places and adapt it for utilization elsewhere.[105]

Global management skills

The second trend involves the growing availability of well-trained, competent host-country nationals prepared to manage businesses within their borders. As organizations have achieved access to larger, broader markets by globalizing, host countries have increased the number of jobs in their economy, improved their standards of living, and benefited from transfers of technology. The improved ability of host-country nationals to direct and manage enterprises is a form of technology transfer. In addition, in almost all cases, it's cheaper to employ host-country nationals than to use expatriates, particularly if the reference point for expatriate compensation is a country that has both high management salaries and a strong currency.[106] AT&T estimates that expatriate managers cost three times as much as host-country nationals. And yet, the assignment failure rate among expatriates is considerably higher than the failure rate for host-country nationals.[107] Similarly, it is estimated that moving one American worker to China costs $600,000 per year.[108] Even so, while many multinationals are developing management capability at the local or regional level, there continues to be widespread use of expatriates to manage offshore operations.

Two traditional approaches exist in the area of international compensation for expatriates: (1) the **going-rate approach** and (2) the **balance sheet approach.**[109] In the going-rate approach (also known as the **market-rate approach** or the **localization approach**) pay is linked to the prevailing pay in the local (or regional) area. When using the approach for expatriates, however, the organization must carefully consider its relevant market and the reference points it will use. For example, a Japanese bank operating in New York City, using a management team from Japan, would need to decide whether its reference point would be local U.S. salaries, other Japanese competitors in New York, all foreign banks operating in the area, or other Japanese expatriates in the region.

The traditional approach used by U.S. companies for compensating expatriates is the **balance sheet approach,** in which the goal is "to keep the expatriate whole." This usually means that pay equity focuses on other home-country colleagues and compensating the individual for the additional costs of an international assignment. What happens to third-country nationals? Traditionally, companies headquartered in the United States used U.S. pay practices as the reference point for U.S. expatriates and home-country practices as the reference points for third-country nationals. This most certainly saves money, but it can create serious pay inequities when expatriates from different home countries work together.[110]

International pay scales

An emerging approach resolves this dichotomy by developing an international pay scale that ties all expatriate pay to some common reference point. This approach means that pay remains relatively equivalent regardless of the location of a particular assignment, or the home country of a particular expatriate. This approach further standardizes international compensation and moves it away from an individual, case-by-case focus.

Three factors typically influence an organization's approach to international pay design, particularly when expatriates are used.[111] First, the expected length of the assignment influences the type and amount of special benefits and allowances. Assignments lasting less than 1 year typically do not require major modifications to domestic pay practices. Second, the degree of mobility expected of the expatriate influences practices. Assignments that require the employee to move from one foreign location to another will probably require greater incentives to offset family disruptions. Third, the desired reference point to be used for pay equity purposes makes a difference in pay program design. Some companies are beginning to use host-country pay levels (i.e., the going-rate approach described earlier) for expatriates on long-term assignments, because they believe that such an approach facilitates an individual's integration into foreign countries and avoids obvious pay inequities within local work groups.

Compensation for international assignments typically has four components, each of which is explained next: (1) base salary, (2) foreign service premiums, (3) allowances, and (4) benefits.

Base Salary

In international compensation, base salary represents the amount of cash compensation that will be provided to an individual each pay period, plus it often serves as a reference point for calculating other allowances. Base salary may be paid in parent- or host-country currency. If parent-country currency is used, the organization must monitor fluctuations in the exchange rate (since the expatriate will be required to exchange the money in order to make local purchases). If host-country currency is used, the organization must monitor the country's inflation rate and changes in the cost of living (to ensure that the expatriate's purchasing power does not inappropriately erode).

Foreign Service Premiums

Foreign service premiums are monetary payments above and beyond base salary that companies offer in order to encourage employees to accept expatriate assignments. Such premiums typically apply to assignments that extend beyond a year. Foreign service premiums tend to range between 10 and 30 percent of base pay.[112] Companies typically disburse premiums to expatriates through periodic lump-sum payments in order to remind the individual that the payment is directly tied to the international assignment.[113]

Hardship premiums are used to compensate expatriates for exceptionally hard living and working conditions in some foreign locations. Many organizations refer to the U.S. Department of State schedule that uses three criteria in identifying hardship: (1) difficult living conditions due to inadequate housing, isolation, inadequate transportation facilities, and lack of food or consumer services; (2) physical hardship relating to extreme climates, high altitudes, and the presence of dangerous conditions that might affect physical and mental well-being; and (3) unhealthy conditions, such as diseases and epidemics, lack of public sanitation, and inadequate health facilities. At the time of this writing, over 400 places have been designated as hardship locations by the U.S. Department of State. Hardship allowances range from 5 to 35 percent of base salary. Like foreign service premiums, organizations tend to provide them in periodic lump-sum payments. **Danger pay**

Figure 10-15
U.S. Department of State Indices of Hardship Differentials and Danger Pay—Effective May 8, 2011

City, Country	Hardship Differential	Danger Pay
Kabul, Afghanistan	35%	35%
Minsk, Belarus	25	—
Beijing, China	15	—
Bogota, Colombia	5	15
Santo Domingo, Dominican Republic	15	—
Tallinn, Estonia	10	—
Athens, Greece	5	—
Port-au-Prince, Haiti	30	5
New Dehli, India	20	—
Baghdad, Iraq	35	35
Jerusalem (West Bank)	5	20
Antananarivo, Madagascar	25	—
Mexico City, Mexico	15	—
Islamabad, Pakistan	25	35
Lima, Peru	15	—
Warsaw, Poland	0	—
Moscow, Russia	15	—
Riyadh, Saudi Arabia	20	15
Freetown, Sierra Leone	30	—
Ankara, Turkey	10	—
Caracas, Venezuela	20	—

Sources: http://aoprals.state.gov/web920/hardship.asp and http://aoprals.state.gov/web920/danger_pay_all.asp. Accessed May 12, 2011.

compensates employees for their willingness to work in politically unstable places. The State Department currently designates over 70 places as dangerous locations. Figure 10-15 shows a sample of some hardship and dangerous locations and the percent differential paid for working in these areas.

Allowances

There is great variation in the types of allowances that are used in international compensation. Changes in **purchasing power** due to inflation and **exchange rate** fluctuations (both mentioned earlier) are typically handled with cash allowances. Most organizations provide some type of **housing allowance** in order to provide a level of comfort to the international worker. Depending on the company and the country, housing allowances range from company-provided housing (mandatory or optional), to a fixed-dollar cash bonus, to a cash allowance calculated as a percentage of base salary. **Educational allowances** provide for a variety of needs and are mainly focused toward the expatriates' children. Possible allowances include the cost of private or boarding schools, language class tuition, books and supplies, room and board, and uniforms. **Relocation allowances** typically cover moving, shipping, and storage charges; temporary living expenses; subsidies for major appliance or car purchases; and lease-related charges. Some organizations provide special **spouse assistance** to help offset income lost by an expatriate's spouse as a result of relocating abroad. Allowances include cash payments equivalent to the spouse's former wages, assistance in locating suitable employment in the new location (e.g., paying search fees), and continuing supplements if the spouse's income is less than previously earned. Many companies offer **home leave allowances** in order to encourage the maintenance of ties with family and friends. Such allowances usually cover all expenses relating to visits back to the home country (usually, two trips per year).

Expatriate Benefits

In many ways, expatriate benefits are a bigger problem in international compensation than pay. Employee benefits and the related tax issues vary considerably from country to country. Key questions that an organization needs to ask itself when dealing with the benefits of expatriates include: "Should we keep expatriates in parent-country programs, even if we do not get a tax deduction for it?" "Can we legally enroll the individual in the host-country benefits and make up the differences in actual coverage?" "What should we do about Social Security issues?” Within the European Union, Social Security is portable. It is not in most other places in the world.

Most U.S. expatriates remain under their parent-country’s benefit plan, although there is a trend among organizations toward purchasing benefits to cover all expatriates wherever they are located.[114] In countries where employees may not opt out of Social Security (or other mandatory retirement) coverage, the firm will typically cover this expense.

Taxation issues

One particularly challenging international compensation problem involves taxation.[115] For U.S. expatriates, an assignment overseas often means that they will be double-taxed—both in the country of assignment and in the United States. Most organizations choose between two strategies for managing taxes on behalf of their expatriates. In the **tax equalization approach,** firms withhold taxes based on the home-country tax obligation and pay all taxes in the host country. The **tax protection approach** involves the employee paying all taxes up to the amount he or she would pay in the home country. Under this approach, considering the tax credit for foreign earned income provided by the United States, if taxes in the foreign country are less than those that would have been paid in the United States, the international employee gets to keep the windfall.

SUMMARY

Because of the importance that compensation holds for their lifestyle and self-esteem, individuals are very concerned that they be paid a fair and competitive wage. Organizations are concerned with pay, not only because of its importance as a cost of doing business, but also because it motivates important decisions of employees about taking a job, leaving a job, and performance on the job.

Base pay

When designing **base salary** compensation plans, it is important that an organization choose an approach that is in alignment with its organizational philosophy and that supports its organizational goals. In some cases, the traditional approach to pay still provides the best answer. This approach involves the use of a job evaluation plan (to measure internal job worth and to foster internal equity), the review of market salary data (to identify externally competitive practices), and the reconciliation of these two in the form of a final pay structure. Due to the basic changes in organizations today and the new global challenges and opportunities, there is a growing search for new compensation approaches in the hope that they will better focus employees on achieving organizational goals. Such new approaches to pay include market-based pay programs, broadbanding, pay for knowledge (or skills-based pay), and team pay plans. To date, however, the relative effectiveness of these new approaches remains to be tested.

Employee benefits

Employee benefits programs are also the subject of considerable evaluation with many variations in the benefits that are offered by organizations. Benefits mainly have been directed at assisting employees in maintaining a particular lifestyle and providing for their long-term welfare and security. The rise of flexible (or cafeteria) benefit plans suggests the importance of considering individual preferences, the increasing diversity of the workforce, and lifestyle realities when structuring an employee benefits program.

The government’s goal concerning its regulation of pay and benefits is to ensure that discrimination does not exist and that certain minimum levels of fairness are maintained in compensation programs. A number of federal, state, and local laws also regulate compensation, and new laws are likely.

Base pay programs and fringe benefit programs must be assessed for the extent to which they attract, retain, and motivate the workforce relative to major competitors. The cost of labor is critical to corporate performance and must be constantly monitored to determine whether costs can be reduced with no loss in fulfilling the organization’s strategy. By the same token, when required skills for competitive advantage are in great demand, companies that do not respond with competitive pay packages will lose out. While America’s most admired companies such as Coca-Cola, Mirage Resorts, United Parcel Service, and Microsoft all take steps to control and (at times) reduce their labor costs, they also make certain that their compensation packages attract, retain, and motivate their key personnel.

Regardless of which particular compensation program is chosen, organizations need the capacity to measure individual or group results so that such performance may be reflected in pay. The next chapter will look at the methods that are used to reward employees for their contributions to an organization. These decisions are by no means easy, but when combined with other components of compensation, an effective pay-for-performance program can be a powerful tool with which to attract, retain, and motivate a high-quality workforce.

It is estimated that 47 percent of private-sector employees in the United States have had at least part of their compensation tied to their company's profitability or stock price. According to one review, if you include stock options, deferred stock, profit sharing, and cash bonuses that are linked to a company's performance, almost 50 percent of the 114 million employees of private-sector companies had some form of stock or profit-related pay.[116]

It is now clear that many of these pay-for-performance programs were deeply flawed and contributed to the unfortunate economic events that began in 2007. Bankers, traders, and lenders were encouraged to take short-term risks with little responsibility for their actions. Managers at publicly traded institutions, among them, Lehman Brothers, Washington Mutual, Countrywide Financial, Bear Sterns, Morgan Stanley, and Citigroup, encouraged their traders and lenders to do larger and riskier deals. When things were going well, these employees, their managers, the firms' executives, and the stockholders all prospered (especially the executives). Money was made by simply doing a lot of business deals with no apparent consideration of the long-term risk and implications.

The new leadership in Washington may soon take significant action to regulate corporate compensation programs. As one expert on the subject of Wall Street compensation put it, "after nearly 18 months spent doing triage on one of the worst financial crises in our nation's history, there is now a shred of hope that those who are in a position to do something about the root cause of the problem—Wall Street's bloated and ineffective compensation system—just might act."[117] The Dodd-Frank Act is one example of action taken. At the time of this writing, the Health Care Reform Act continues to be implemented, although the road to achieving the goals originally stated for health care change is still very unclear.

Discussion Questions

1. Research CEO pay on the Internet (try www.aflcio.org/paywatch and Graef Crystal's columns at www.bloomberg.com/columns). Identify persons you believe to be the most overpaid and underpaid and explain why. Determine if any new legislation or regulation could affect executive pay.
2. It has been proposed that HR managers should be more involved with compensation committees charged with determining executive pay packages. How should HR be involved?
3. Critique market-pricing pay with the traditional approach to compensation. Which approach is more important for organizational effectiveness? Which approach would you implement and why?
4. Pay expert Ed Lawler says pay the person, not the job. Explain what you think he means and how that would work.
5. What is broadbanding and what does the latest research say about its effectiveness?
6. The Paycheck Fairness Act has been proposed to promote pay equity. Research this legislation and determine its status and/or effects.
7. A constant political debate is whether or not the minimum wage should be increased. Research this topic and justify your position on the topic.
8. Some argue that workers' compensation programs and the FMLA have proven to be problematic laws for employers. Research these issues to determine the recent controversies and proposed solutions. Why are there so many lawsuits regarding overtime?

9. The chapter covers the two problem areas of Dodd-Frank's "clawback" provisions. If you were the regulator, how would you resolve those questions in actual application (and be specific . . .)? Research cases involving potential clawbacks under Sarbanes-Oxley and/or Dodd Frank.
10. Consider the case of Jacobs Engineering and its 2011 experience with "say on pay." Understanding that say on pay is an "advisory shareholder opinion," how do you think organizations (like Jacobs) will be affected (if at all), if they refuse to accept shareholders' say on pay?
11. Research the current trends in defined contribution versus defined benefit programs. From the employer's perspective, what program is preferable and why? Now consider the employee's perspective.
12. What is the most typical pay policy for expatriate assignments? How would you determine the entire pay package?

Chapter 11 Rewarding Performance

OBJECTIVES

After reading this chapter, you should be able to

1. Understand the determinants of effective reward systems.
2. Identify the critical variables related to the selection of the most appropriate systems.
3. Describe the evidence on the effectiveness of different types of reward systems.
4. Understand the relative advantages and disadvantages of the various approaches to reward effective performance.

OVERVIEW

The single largest operating cost for a company is employee compensation, so it's very important that a firm get a good return on its investment. As discussed in Chapter 10, compensation refers to all forms of financial returns and tangible services and benefits that employees receive as a part of the employment relationship. The 2011 Most Admired Companies rated by *Fortune* magazine revealed that in the top companies (e.g., Apple, Google, Berkshire Hathaway, Southwest Airlines, Procter & Gamble) rewards are linked to performance effectively (using incentive pay such as bonuses and merit salary increases) at 89 percent of these firms vs. 77 percent of their industry peers.[1] A strong trend in compensation administration over the last 15 years has been the installation of various forms of reward systems for employee performance, often called "pay-for-performance" (PFP) or performance incentive systems. In fact, PFP plans are not only prevalent in the private sector, but are also becoming more popular in places where they have not traditionally been used, such as the public sector, education, and health care.

The term ***pay-for-performance*** is a little misleading since many performance-based incentive systems now award something other than pay for desired performance. During prosperous economic times, luxury cruises, golf outings, and trips to Las Vegas are common parts of such incentive programs. The terms "pay-for-performance," *reward,* or *incentive* systems are used interchangeably in this chapter. In general, these incentive pay systems put more employee pay at risk compared to the more traditional pay systems and loosen the relationship between assignments and pay levels. This loosening seems to provide more flexibility for organizations.

What better way to motivate employees to be more focused on meeting (or exceeding) customer requirements and increasing productivity than to establish a closer connection between meeting such requirements and compensation? Research has found certain characteristics of such reward systems to be major elements of **"high-performance work practices"** and linked such systems to bottom-line firm performance, particularly when what employees are rewarded for is closely aligned with the company's strategic objectives and a high percentage of employees participate in the plan.[2] Controlling labor costs and increasing productivity through clearer linkages between pay and performance are key human resource management (HRM) components of competitive advantage.

Evidence on PFP is positive but many caveats

Many firms jump on the PFP bandwagon without thoroughly understanding the potential difficulties and limitations of PFP systems. A comprehensive review of the literature concluded that "the evidence on PFP is generally positive. To be sure, there are some very important caveats: pay is not the only important motivator in organizations, and PFP programs can yield serious, unintended negative results."[3] There are clear guidelines to follow, and failure to follow them can doom a PFP system.

Classic PFP failures

There are many classic failures of pay-for-performance systems. Harvard Professor Kevin Murphy summarized the research on PFP nicely: "Business history is littered with firms that got what they paid for."[5] Sears had a very clear PFP system in which mechanics were paid bonuses as a percentage of repair receipts. Receivables went up, mechanics got higher pay, and 41 states indicted Sears for fraud. Columbia Hospitals is probably another example of getting what you pay for in a PFP system. When you can increase your profits by "gaming" a government entitlement system like Medicare, the government just might think the "gaming" constitutes fraud.

Paying teachers for higher student test scores invites "teaching to the test" or worse unless proper safeguards are put in place. At least 10 states now require that student scores be a major (or the main basis) for a teacher's evaluations. Some states now reward teachers for raising scores. In Washington, D.C., teachers could earn up to $25,000 bonus pay if their students' test scores improved. There are several examples of fraud related to student test scores after such "high stakes" test scores became linked to teacher pay (and retention). One was exposed in a 2011 probe by the state of Georgia concluding that teachers and principals in numerous Atlanta public schools changed test papers to improve scores.[4]

New York State discovered internal e-mails blasting companies that Merrill Lynch analysts were pushing as "strong buys." Merrill settled a lawsuit for $100 million. Morgan-Stanley lost a similar lawsuit when a Florida jury determined that it was fraudulently pushing Sunbeam stock with full knowledge that the stock was overpriced. Morgan-Stanley was assessed $1 billion in punitive damages.

More recent examples of classic PFP failures include the dissolved investment bank Bear Stearns, which provided lucrative incentive packages for its sales force to sell very risky bundled mortgage notes, and the bankrupt Countrywide Financial, which provided great incentives for the approval and writing of highly risky and ultimately defaulted home mortgages that destroyed the company. In both these cases, individuals cashed in based on their sales incentive system while leaving the company in shambles with deals that went very bad. Says pay consultant Alan Johnson, "Wall Street is a sales business—they sell bonds, securities, transactions, ideas. . . . They're not paid to be long-term, philosophical, reflective. The pressure is to do the next merger, sell more stocks and bonds, do more trading—whatever boosts current profits and bonuses, the long-term consequences be damned."[5]

"Cheating is a primordial economic act"

In the best-seller *Freakonomics,* authors Stephen Dubner and Steven Levitt put it this way: "For every clever person who goes to the trouble of creating an incentive scheme, there is an army of people, clever and otherwise, who will inevitably spend even more time trying to beat it. Cheating may or may not be human nature, but it is certainly a prominent feature in just about every human endeavor. Cheating is a primordial economic act: getting more for less. So it isn't just the boldface names—inside-trading CEOs, ballplayers and perk-abusing politicians—who cheat. It is the waitress who pockets her tips instead of pooling them. It is the payroll manager who goes into the computer and shaves his employees' hours to make his own performance look better. It is the third-grader who, worried about not making it to the fourth grade, copies test answers from the kid sitting next to him."[6]

One of the primary causes of the subprime mortgage and home foreclosure crisis was the combination of mortgage loan applicants who exaggerated their incomes on their loan applications and the mortgage brokers, paid primarily contingent on the number of loans that were approved (not paid off), who had little or no incentive to verify these incomes. Needless to say, organizations need to be very careful about setting up the performance measures used for their PFP systems. Indeed, some experts maintain that flawed compensation systems in the form of incentive systems with short-term performance measures and no consideration of long-term effects were at the heart of the economic crisis of 2008.

PFP systems are very common for executives, often in the form of stock options and stock grants. Stock options become valuable when a company's stock price rises above a level set in the option. Options are supposed to provide an incentive to improve a company's stock performance. However, it turns out that many times options are backdated to a date when the stock price was low to allow executives to exercise an unwarranted option. **Backdated options** are set at a low stock price to make them immediately valuable. In a classic case of "take the money and run," Countrywide Financial's chief executive, Angelo R. Mozilo, realized $121.5 million from exercising stock options and was awarded $22.1 million of compensation in 2007, a year in which Countrywide lost $704 million, and its shares declined 79 percent. On the edge of bankruptcy in 2008, Countrywide was purchased by the Bank of America at firesale prices. Over 15,000 Countrywide employees lost their jobs.

Option backdating

Over 200 companies have been the subject of government investigations into whether option dates were chosen to ensure maximum profit, a process that is illegal if not properly accounted for on company books. Brocade Communication's former chief executive, Gregory L. Reyes, was convicted of criminal charges over backdating. He was sentenced to 21 months in prison and fined $15 million. Brocade's former personnel director was also sentenced to prison for backdating options.

There are few objective defenders of the obscenely exorbitant pay for U.S. CEOs these days. Since 1990, when U.S. CEO pay was already substantially higher than European and Japanese CEO pay, U.S. CEO compensation has risen over 600 percent while the average American worker's pay increased 38 percent.[7] Most of the increase in CEO pay is due to the so-called PFP components of the pay package and, in particular, stock options. Compensation that is overloaded with stock options drives executives to focus on stock price and drive the stock price up using whatever chicanery is available.

Many of our most successful companies have endeavored to establish a stronger connection between employee pay and strategic goals. Federal Express, for example, won the prestigious Malcolm Baldridge Award and credited the clear linkage it had established between worker pay and customer satisfaction data. Stanford Professor Jeffrey Pfeffer, whose research is discussed in Chapter 1, has identified a successful PFP system as a key to the success of some of the most profitable companies in the United States.[8] Lincoln Electric Welding is one such company. Pfeffer attributes Lincoln Electric's success to its incentive management program (go to www.lincolnelectric.com for details on the program). But he also emphasizes that Lincoln's PFP system could only be pulled off in the context of a management system based on great trust between workers and management.

PFP can be a key to success

One survey of the largest United States companies found that 90 percent connect at least part of some employees' pay to performance.[9] Among the many companies that have implemented some form of PFP system for nonmanagerial employees in recent years are General Motors (GM), the Tribune Company, Coca-Cola, Burger King, Office Depot, Mirage Resorts, United Parcel Service (UPS), Grumman, and Wal-Mart. One of the strongest trends in services is the formal use of customer data in reward systems for individuals, work units, and stores. Office Depot, for example, has a number of bonus systems based on assessments conducted by "mystery shoppers" (see Chapter 7). One survey of 2,719 midsize companies found that 30 percent of companies paid lump-sum bonuses averaging 3.5 percent of annual salary.[10]

The purpose of this chapter is to review the major types of PFP systems and to discuss their relative advantages and disadvantages. The determinants of effective PFP systems are described first, followed by an exploration of questions of fairness and practicality regarding PFP. Next, the major problems associated with PFP are reviewed.

Reward systems come in all shapes and sizes. One of the most important considerations is the **level-of-performance measurement.** The most common type of PFP is to tie pay to individual performance in a merit pay system. However, in an effort to promote teamwork, a growing number of companies now tie pay to unit or group performance, and others tie pay to organizational or company performance. Within each of these three general categories, however, there are numerous approaches. As discussed in Chapter 7, the accurate measurement of performance and the linkage of the performance measures to the strategic long-term goals of the organization are the keys to successful PFP efforts.

DOES PFP WORK?

Experts in the area of PFP have concluded, "the usefulness of money as well as its many symbolic meanings suggests that, far from being a mere low order motivator, pay can assist in obtaining any level on Maslow's motivational hierarchy, including social esteem and self-actualization."[11] A study of **"high-performance work practices"** found that certain types of PFP systems and characteristics were correlated with stronger firm performance.[12]

What is being rewarded?

It's clear that PFP systems work. It's also clear that PFP has the potential to cause all kinds of trouble. It all kind of depends on what is being rewarded, what is not being rewarded, and what really matters to the organization. Organizations need to be careful what they wish for. Employees of pure investment banks such as Goldman Sachs and Lehman Brothers took home an average of 60 percent of the revenue of the firms in one year. The prospect of huge bonuses encouraged excessive borrowing and high-risk investment that came back to haunt these companies in 2008 after the bonus money had been dispersed. Numerous corporate executives and their sales forces got very rich, but the companies and their stockholders were far worse off in the long run. Lehman and another investment bank, Bear Stearns, did not even survive. Obviously, **what is measured and what is rewarded are critical factors in the success or failure of PFP systems.** Organizations must ensure that short-term performance measures are correlated with more important long-term strategic goals and outcomes. This seems to be happening since a 2010 *Wall Street Journal*/Hay Group study revealed that the structure of pay in firms saw meaningful changes as more companies increased their emphasis on performance-oriented long-term incentive programs. As noted in the study, "after a turbulent 2009 in which companies moved towards retention-oriented time-vested stock plans, they reversed course in 2010 by increasing their emphasis on plans that only pay out when companies achieve long-term objectives."[13]

Short-term measures must correlate with long-term measures

A great deal of the economic crisis of 2008 can be explained by incentives and the "gaming" of incentive systems. A lot of what Countrywide Financial, Lehman Brothers, and Bear Stearns did was sell "paper." They sold mortgages (albeit really risky ones), bonds, securities, and "credit swaps" (all linked to those risky loans), and they were paid essentially at the point of transaction. Their incentives were to sell more stuff that would boost the "bottom line" and make executives and shareholders happy. With the exception of the top management team, the CEO and the board, all of whom were apparently asleep at the helm, these employees weren't paid to consider (or incorporate into their selling strategies) the long-term consequences of their actions. So they didn't.

Contingency factors

Experts provide a number of important **"contingencies"** or conditions, which are related to the relative effectiveness of reward systems. Figure 11-1 presents a summary of the most important contingencies. You will note that the characteristics of the employee matter. Effective systems are particularly important for attracting and keeping top talent. High performers are more receptive to and also more critical of PFP systems. The characteristics of the reward system are critical as well. Changes to pay systems, particularly without employee input, can also have a significant negative impact. One study found over a 100 percent increase in employee theft after the company cut pay by 15 percent with no explanation.[14] Also, while pay will have little effect where people receive similar pay increases despite large differences in performance, dramatic changes in performance can occur when pay is made more contingent on performance. Regarding marginal utility, there is evidence that being "under market" has a stronger motivational impact than does the

Marginal utility

Figure 11-1
Examples of Contingency Factors Affecting Pay Importance

Individual Difference Contingencies

1. Pay is more important to extroverts than to introverts.
2. Receiving performance-based pay is more important to high academic achievers than to others.
3. High-performance employees appear to be particularly sensitive to whether their higher performance is rewarded with above-average pay increases, while low performers prefer low-contingency pay systems.
4. People with high need for achievement and higher feelings of self-efficacy prefer pay systems that more closely link pay to performance.

Situational Contingencies

1. Pay is more important in job choice when pay varies widely across employers than when pay is relatively more uniform.
2. There is a declining marginal utility to additional increments of pay.
3. The salience or "importance" of pay is likely to rise after *changes* are made to pay systems. Employees are particularly sensitive to pay *cuts*.
4. Employee reactions to changes in pay depend heavily on communication of the *reasons* for pay policies and changes.
5. Pay is probably more important in job choice than in decisions to quit.
6. Pay will do little to motivate performance in systems where people receive similar pay increases regardless of individual or firm performance. However, dramatic changes in performance can occur when pay is made more contingent on performance.

Source: Adapted from S. L. Rynes, B. Gerhart, and K. A. Minette, "The Importance of Pay in Employee Motivation: Discrepancies between What People Say and What They Do," *Human Resource Management* 43 (2004), pp. 381–394.

positive effect of being "above market." Job candidates often reject offers simply because of the pay. Pay is probably relatively more critical in terms of job choice than in decisions to quit because pay is one of the few characteristics people can know with certainty before taking a job.

The bottom-line on reward systems

The bottom line on the effects of reward systems is that such systems can be very effective if they are tailored to particular work situations and strategies and enhance the connection between worker effort and desired rewards. Above all, they are effective if they reward performance in those areas most important for the long-term success of the organization.

Domino's Pizza claimed an increase in sales in excess of 20 percent after implementing a PFP system. International Business Machines (IBM) attributes a 200 percent increase in productivity to its PFP system. One survey reported improved output from two out of three companies using some form of PFP when incentives were provided for meeting specific performance targets.[15] **The evidence is strong that PFP systems are effective when what an organization is actually rewarding is highly compatible with its long-term strategic objectives and execution.[16]**

Compatibility with long-term objectives is the key to success

The events of 2008, particularly irresponsible lending practices, underscore the need for this compatibility. Countrywide Financial has been called the "poster child" for the subprime mortgage crisis. A $500 billion home loan machine, most of Countrywide's sales staff and lenders, its managers, and its executives made huge sums of money in 2006 and 2007 through highly risky subprime lending. Borrowers with questionable credit histories, who probably should not have been granted home loans in the first place, were unable to make their mortgage payments and defaulted on their loans. By late 2007, the company had lost over $700 billion, the stock price fell 79 percent, and over 15,000 employees had lost their jobs. Unfortunately, there are many other stories like Countrywide's where bad incentive systems rewarded highly risky behavior that ultimately doomed companies.

WHAT ARE THE DETERMINANTS OF EFFECTIVE REWARD SYSTEMS?

Although pay is generally regarded as a motivator, organizations are often confronted with unique sets of issues and problems related to PFP and therefore must develop strategies to deal with them. Employers are often interested in rewarding their highest achievers and being able to motivate others to work harder to meet the organization's goals, yet often managers do not lay the necessary foundation to create a PFP system. The most important

Figure 11-2
Determinants of Effective PFP Systems

Individual Employee Factors

1. Employee values outcomes (money, prizes).
2. Outcome is valued relative to other rewards.
3. Desired performance must be measurable.
4. Employee must be able to control rate of output or quality.
5. Employee must be capable of increasing output or quality.
6. Employee must believe that capability to increase exists.
7. Employee must believe that increased output will result in receiving a reward (i.e., have self-efficacy).
8. Size of reward must be sufficient to stimulate increased effort.
9. Performance measures must be compatible with strategic goals for short and long term.

Organizational Factors

1. Employer must have a culture that supports the PFP system.
2. Employer must have competent supervisors (capable of measuring performance and using the system).
3. Employer must have a good performance appraisal system.
4. Employer must have adequate funding for pay increases.
5. Employer must have a fair process.
6. Employer must provide training for supervisors and employees on the PFP system.
7. Employer must continually evaluate the process and make improvements.

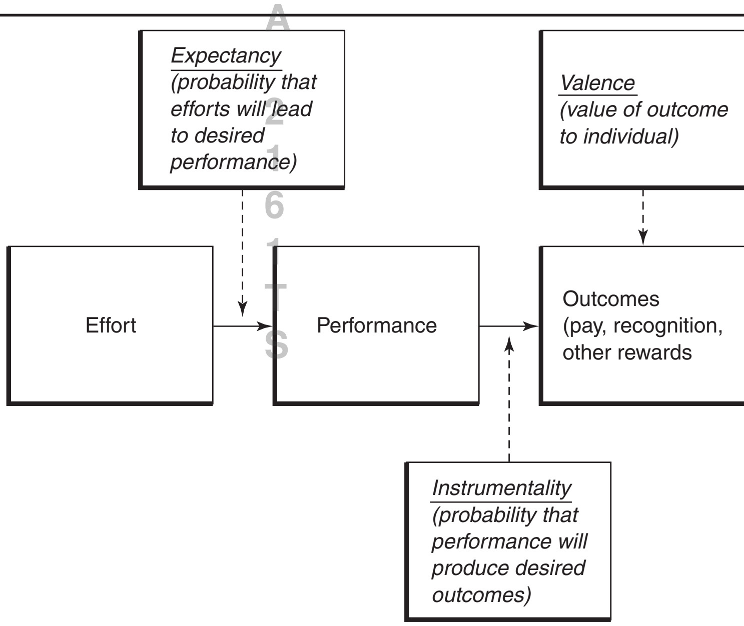
Source: Adapted from S.L. Rynes, B. Gerhart, and K.A. Minette, "The importance of pay in motivation: Discrepancies between what people Say and What they do," *Human Resource Management*, 43, (2004), pp. 381–394.

determinants of effective PFP are summarized in Figure 11-2. These include both individual employee factors and organizational (employer) factors.

Expectancy/instrumentality theory (Figure 11-3), particularly when combined with **goal-setting,** has a great deal of predictive power in understanding PFP systems. Expectancy/instrumentality theory explains why more pay often leads to higher performance and why in other cases the connection is often not all that strong.

Motivation is a function of the perception a worker has about the likelihood or probability that working harder will lead to higher performance and the probability that higher performance will lead to valued outcomes like more money. Of course, performance is also a function of a worker's knowledge, skills, and abilities. A worker's perception of the critical effort-to-performance relationship is to some extent a consequence of that worker's self-assessment of his or her KASOCs as related to the work. In addition, if workers believe that situational constraints beyond their control have more to do with performance than their own effort or competencies, their perception of the probability that effort will lead to higher performance will be very low (see individual employee factors 4–6 in Figure 11-2). While the determinants presented in Figure 11-2 can increase the likelihood of an effective PFP system, all are not required for an effective PFP system.

Figure 11-3
Expectancy/Instrumentality Theory



Unions and PFP

Increases in pay as a reward for increases in performance must be valued by the specific employee or work unit for which the PFP plan is intended—and must be valued highly relative to other rewards. Occasionally group norms or cultural values deemphasize money as a reward for performance, or oppose differential rewards for differential outputs. Unions, for example, have traditionally opposed pay systems based on individual output, such as piece-rate incentive systems. Some unions (e.g., the United Auto Workers, the Communication Workers of America, and the Teamsters) have become more receptive to PFP systems in recent years when trust is established between the union and management. The Teamsters have supported a profit-sharing plan for UPS workers in their latest collective bargaining agreement. The National Education Association, the largest U.S. union and a long-time opponent of pay-for-performance, has expressed recent, albeit begrudging, support for tying teacher pay to students' performance.

These examples are certainly exceptions rather than the rule. In general, unions strongly favor organization-wide or plant-based PFP systems and not individual PFP systems, which the unions maintain will inevitably pit worker against worker. Unions typically resist reward systems that are linked to individual performance. When the state of Florida first mandated an individual merit pay system for teachers, the American Federation of Teachers (AFT) worked diligently to promote regulations regarding the merit pay process, which ultimately led to the demise of the system. Within 2 years, the state had rescinded the individual PFP program. The state of Florida passed a new pay-for-performance law in 2011, linking teacher pay to student test performance. This new law was also opposed by the teacher unions. We'll soon see whether this new approach to teacher pay will improve student outcomes.

Some companies also regard individual PFP systems as contrary to their team-oriented philosophy of management and organizational culture. United Technologies is one example. Its PFP reward system uses only aggregated methods of rewards in which unit and company-wide performance measures are the basis of the awards.

The organization must identify those measures of performance (e.g., customer data, outputs, products, services, behaviors, cost reductions) that are most compatible with their short- and long-term strategic goals and their execution. For example, increased output may be desirable only in situations in which there is customer demand for more of the product. Needless to say, **the organization should tie pay only to those aspects of value that are critical for the organization.** You may recall from Chapter 7 that six aspects of value in the measurement of performance were identified. While most organizations place equal weight on the quality and the quantity of performance, some companies have a clear preference for one of these aspects over the other. (See Figure 7–4, p. 247)

Quantity and quality are aspects of value

The PFP system should establish a reward system for those aspects of value that are compatible with the short-term and long-term strategic goals of the *organization.* For example, retailers often offer incentives for the sale of certain merchandise that is overstocked. Inventory control and sales projections drive the time range for the incentive system. Marriott's strategic goal was to be the "hotel of choice" for business travelers. It established a telephone survey of its patrons' experience and then tied the customer satisfaction data to bonuses. Home Depot outsources all of its home installations, and it does a follow-up survey of customers of the recommended installers in order to determine whether they were pleased with the service. A favorable review gets the vendor a small bonus while an unfavorable review could doom the vendor.

The reward criteria are critical

The proper emphasis on criteria can be tricky but can make or break a reward system. Inspectors working for the Federal Emergency Management Agency were paid per inspection after a hurricane in Florida. The result was a whole lot of fraudulent inspections leading to over $10 million in awards for damages that didn't occur. In another example, one state public service commission provided rewards to traffic officers for finding illegal drugs being transported in trucks. It had to drop the new incentive system once it discovered that some of the officers were fabricating reports or placing the drugs in the trucks in order to "find them." In 2008, some divisions of the Association of Community Organizations for Reform Now, or ACORN, paid canvassers for each voter registration form submitted. Among the prospective "voters" who submitted registration forms were Mickey Mouse and Donald Duck. Only when ACORN adjusted its "piece-rate" incentive system to pay for validated registration forms did these rather suspicious forms cease to be a problem. We've already discussed the bad home loan applications processed by loan agents who were paid for loan approvals, not for the loans actually being paid.

Perhaps because of the Exxon *Valdez* oil spill off the Alaska coast, Conoco made environmental issues a major strategic priority. Environmental criteria became a component of its incentive system for top managers. Xerox Corporation places great emphasis on customer service and now uses customer survey data as a criterion in its bonus system. According to Xerox's president, it is possible that an executive of a profitable unit would not get a bonus at all if the customer survey data indicated poor performance. The Aluminum Company of America now emphasizes improvements in safety records as a part of its managerial bonus system. Workers at a Monsanto Corporation chemical plant in Louisiana can earn bonuses for meeting goals that include reducing injuries and preventing emissions from escaping into the environment. As a part of the settlement of a class-action racial discrimination lawsuit, Texaco places considerable weight on diversity issues in its PFP plans for executives. Executives are evaluated and paid based on their ability to keep and develop minorities and women. Wal-Mart installed a similar program in the context of its huge class-action, sex discrimination lawsuit.

Worker involvement in PFP design is important

Successful PFP systems recognize that all of the determinants presented in Figure 11-2 are intimately related. For example, to determine the nature of a reward that should be offered for an increased level of effort, a firm must know the relative importance of the reward to its typical worker, the increased value to the firm of any given performance increase, and the worker's perception of the increased effort required and the likelihood of receiving the reward. Money fails to motivate if the required level of extra effort results in unacceptable fatigue to the worker or prevents the worker from enjoying a valued social life. Success is more likely with more worker involvement in the development of the PFP system. Employee participation in the development will enhance acceptance of the plan. As discussed earlier, high performers are likely to seek out other employment if they do not feel they have been recognized with the financial rewards they feel they deserve.[17]

WHAT ARE THE MAIN PROBLEMS WITH PFP PROGRAMS?

More worker involvement fosters acceptance of changes

There are many potential problems with PFP systems. Figure 11-4 presents a summary of the problems judged by experts to be most responsible for the failure of such systems. PFP systems can be expensive to develop and maintain. In addition to the initial cost of establishing standards and rates, changes in procedures, equipment, and product may require revision of any existing standards and reward structures. In many cases a revision of the compensation system will be viewed with suspicion. Historically, some short-sighted firms have taken advantage of changes in the production process to reduce the amount of reward for any given level of effort. General Motors established what it thought were challenging production targets for a Michigan plant and let workers go home when the targets were achieved. GM then increased the targets when it found that workers were able to go home early. Such actions had a long-term negative effect on worker responses to other GM PFP systems. Again, the more worker involvement in pay plan changes, the greater the acceptance of the changes.

Figure 11-4
Reasons for the Failures of PFP Systems

1. Poor perceived connection between performance and pay.
2. Lack of sufficient compensation budget. The level of performance-based pay is too low relative to base pay. The cost of more highly motivating programs may be prohibitive.
3. Lack of objective, countable results for most jobs, requiring the use of performance ratings.
4. Faulty performance appraisal systems, with poor cooperation from managers, bias in the appraisals, and resistance to change.
5. Union resistance to PFP systems and to change in general.
6. Poor (or negative) relationship between rewarded outcomes and long-term performance measures and objectives.
7. Supervisors who do not take the PFP process seriously.

Problems with performance appraisals

PFP systems have to be able to measure performance either by result-oriented or more objective measures (e.g., profitability, number of units produced) or by behavior-based measures (e.g., supervisor evaluations). While neither of these systems is perfect, more problems can arise in a PFP system that relies on subjective measures or performance appraisals. One frequent problem is that workers do not feel that their rewards are closely linked to their performance, a critical component of expectancy/instrumentality theory. This low probability often occurs when employees believe that the performance *measure* does not accurately reflect their performance. They may feel that the performance measure doesn't fully capture their contributions to the firm or that their supervisor has limited information to use to evaluate them. Or, as discussed in Chapter 7, employees may have inflated ideas about their performance levels, which translate into unrealistic expectations about rewards as well. One study found that the majority of workers who were rated even slightly less than the highest level (e.g., 8 on a 9-point scale) were more dissatisfied than satisfied with the rating. Those with larger discrepancies between their self-assessments and their supervisor's ratings were more dissatisfied with their merit pay increase.[18]

Given their beliefs about their own performances, a large portion of the workforce may receive performance ratings below their expectations, and thus rewards will likely fall short of their expectations. As discussed in Chapter 7, there can be a perception of bias in the process even if such bias does not exist. To the extent that workers perceive that the performance measurement component of the PFP system is biased or invalid, the perceived connection between pay and performance will be undermined and the PFP system will be less effective. This is a common problem when performance is measured by supervisory ratings.

Some experts on PFP go so far as to say that if performance must be measured by supervisory ratings, PFP is not worth the trouble. One such expert concluded that when ratings must be used, "the approach is so flawed that it is hard to imagine a set of conditions which would make it effective."[19] While this conclusion may be overly pessimistic, there is no denying that PFP systems based on single-source ratings of performance can be problematic. In one of the largest Title VII class-action lawsuits to date, it was alleged that Coca-Cola discriminated against African Americans in the manner in which it evaluated personnel and awarded merit increases. Companies should not contemplate PFP until they have great confidence in the accuracy and fairness of their performance measurement system. If ratings are to be the primary basis for the rewards, the use of multiple sources of raters, including customers, if possible, is a preferable strategy over the typical "top-down" supervisory ratings.

Use multiple rating sources if possible

Many PFP plans fail because the performance outcomes that were rewarded were not related to the performance objectives of the entire organization as a whole and to those aspects of performance that were most important to the long-term success of the organization. A PFP system may put inordinate emphasis on the quantity of output when the organizational emphasis should be on quality improvement or cost effectiveness. As one expert in compensation put it, "Misaligned pay strategy not only fails to add value, it produces high costs . . . as well as inappropriate and misdirected behavior."[20] The organization must constantly ensure that the aspects of value that are emphasized in the PFP system are the same ones that are the priority of the organization and **compatible with the long-term strategic goals of the organization.**

Rewarded outcomes must be tied to long-term success

Misaligned pay strategies can be costly

Recall from the discussion of performance appraisal in Chapter 7 that it is possible to weight performance dimensions (which are combinations of job functions with aspects of value: quantity, quality, timeliness, need for supervision, effects on constituents, and cost). This weighting process should reflect the strategic plan of the unit and the organization. Unfortunately, the typical measurement process for PFP systems that does involve quantity and output or sales is far more haphazard than this. In fact, one survey found that the majority of workers who were paid on a PFP system had little understanding of the criteria for performance measurement. If the system is too complex, it becomes problematic for employees to understand what they need to do to get the reward.[21]

The organization also should ensure that workers are *capable* of increasing their performance. You may recall the discussion in Chapter 7 regarding **constraints on performance.** An employee working on an assembly line or operating a machine with a preset speed may not have the opportunity to increase the quantity of performance. For higher pay to result in higher performance, workers must believe in (and be capable of) higher levels of performance. When workers believe that performance standards exceed their capabilities, they will not expend extra effort.

Finally, one of the most common problems with PFP systems is that an insufficient amount of money is available to reward meritorious performance. A recent paper on *Compensation Trends* noted that with merit pay budgets in the 3 percent to 4 percent range that it was unlikely that employees would change their behavior to get from a 3 percent to 4 percent increase.[22] Truly deserving performers often judge the system to be inequitable because there is not enough money in the pool, and they realize that all of their hard efforts to be at the top will go unnoticed. In fact, the truly deserving performers may be paid seriously undermarket and thus be more likely to leave the organization.[23] Regarding the performance-based component, the level recommended for a PFP system is between 10 and 15 percent of the base salary in order for the money to be considered significant and for the PFP system to be effective.[24] However, many companies disperse various rewards at rates far below these recommendations. At Bank of America, an employee earning $5,000 per month who achieved the very highest performance appraisal was eligible for the highest PFP award of 5 percent. This increased her or his earnings $250 per month (before taxes). Most employees who were surveyed about this PFP system didn't think the amount of money involved was worth what they regarded as the extra effort. Many of the highest-rated employees indicated that, despite their "maxed-out" merit increase, they would look for employment elsewhere. When performance ratings are used as the basis for the rewards, pay is rarely seen as sufficiently differentiated, especially among the highest performers.

10–15 percent of base is recommended

WHAT ARE THE LEGAL IMPLICATIONS OF PFP?

As discussed in Chapter 10, all decisions regarding compensation, including all that are derived from PFP systems, are subject to complaints using the same sources of redress discussed throughout the book. PFP systems have been challenged for more subtle forms of alleged discrimination. For example, as discussed here and in Chapter 7, situational constraints on performance can affect the basic fairness and equity of the PFP system and have been the basis of Title VII actions. An office furniture retailer terminated a female employee for failure to meet a sales quota in a difficult territory. She argued that her opportunity to meet the quota was severely restricted by situational constraints that were beyond her control and that men were not so constrained. She also argued that benefits such as providing sample products that were made available to the male sales personnel were deliberately denied her. Her complaint resulted in a large out-of-court settlement. The Wal-Mart class-action sex discrimination case alleged similar discrimination in the pay system, as did the Ford case discussed earlier (see Critical Thinking Applications 5-C and 7-C).

"Disparate impact" and PFP results

The "disparate impact" theory can be used in lawsuits involving reward systems alleging race, gender, or age bias. The company may have to explain why a lower percentage of women or minorities or older workers received merit increases when the PFP system was based on merit ratings, particularly when most raters are white, male supervisors. The statistical finding of "adverse impact" itself puts the employers in a difficult situation, which may require them to defend their pay increase policy or performance measurement system. Organizations should always monitor their incentive decisions for possible "disparate impact" evidence.

HOW DO YOU SELECT A PFP SYSTEM?

In designing a PFP system, while there are numerous questions that need answers, three major questions should be asked and answered first.

1. Who should be included in the PFP system?
2. How will performance be measured?
3. Which rewards or incentives will be used?

The process for developing the characteristics of a performance measurement system applies to the first two questions, which are discussed in Chapter 7.

Who Should Be Included in a PFP System?

In general, all employee groups should be included in a PFP system with one critical condition: the PFP system should be developed with specific groups and conditions in mind. The “devil” is in the details of PFP systems, so production workers, middle management, salespeople, engineers, professionals, and senior executives and top management should probably have different systems. Many companies use very different PFP systems for different jobs. For example, McDonald’s has eight different PFP systems for various classes of employees. IBM has six different systems. Many companies have different PFP systems as a function of their organizational and unit-level strategies, with some form of market share measurement for a start-up product or service, and cost cutting for a more established product or service line. Some companies use a variety of different PFP systems for the same job families. For example, AMOCO has an individual merit pay system, a unit-level PFP component called gainsharing, and an employee stock ownership program (ESOP) for the same employees.

American workers prefer individual PFP systems

Other companies have reward systems that are compatible with an egalitarian culture that attempts to minimize the distance between people at different levels in the organizational hierarchy. In general, however, American workers prefer individual PFP systems where they can control their own destinies. Great deference should be given to this preference unless a compelling argument can be made that individual PFP systems will foster competition among employees that will ultimately interfere with meeting company or unit-level strategic objectives. Companies can also use combinations of individual and unit-based performance measures based on the particular outcome measures that are selected for rewards.

Recommendation: Tailor systems to situations

So the bottom line is that you should try to involve as many workers in a PFP system as possible, but **each system should be tailored to particular work situations.** Organizations should avoid PFP systems that promote individual competition among workers that interferes with meeting major corporate or unit-level objectives.

How Will Performance Be Measured?

The answer to this question will of course vary with the particular workers and work units. Above all, the criteria selected must be compatible with both the short-term and, more importantly, the long-term strategic objectives of the organization. Performance should be measured to maximize the reliability and the validity of the performance measures, with validity being defined as the extent to which the measure used to define performance is correlated with some ultimate criterion of organizational performance.

What Are the Rewards in an Incentive System?

Cash payments, percentage increases in base pay, and numerous noncash prizes are still the most common rewards for performance. While these incentives are flexible and well suited to short-run objectives, stock awards and stock options are an approach for meeting long-run objectives. Stock options are becoming more common for lower-level employees and are a bigger percentage of the raise for lower-level managers. In addition to quarterly bonuses based on “mystery shopper” data, Wendy’s also awards stock to employees for performance and time on the job.

Stock ownership plans

Another company with an employee stock ownership plan is Publix Super Markets. This highly successful privately held company has made *Fortune*’s list of “Great Companies to Work for” for many years. Its stockholders are its 135,000 workers. If you work more than 1,000 hours per year at Publix and work more than 1 year, you get Publix stock. Publix “associates” clearly have a sense of ownership in the company. Says Publix spokesperson Anne Hendricks, “Put yourself in the place of a Publix associate: If you see areas where you can eliminate waste, you’re going to do it, because you’re going to see it in your next dividend check.”

Stock options

Many companies award stock options to the top management team and sometimes other employees. Options are typically additions to upper-management pay that also include a cash bonus. Although there are several types of stock options, the most popular today are incentive options that give an executive the right to purchase stock at a specified price within a designated period. If the company does well and the stock price goes up, everyone is happy. Actually, some CEOs have made out all right even if the stock price went down as corporate boards awarded new options and lowered exercise prices. As discussed earlier, options have developed a bad reputation lately due to the numerous examples of corporate executives making millions exercising options just before a stock went down and accusations of **backdating stock option** awards to increase the value of the options. Executives and HR managers have gone to jail for backdating.

Many highly successful companies also offer options to lower-level employees. Some experts argue that Federal Express has low turnover among its drivers and maintains a union-free environment at least to some extent because these employees own a part of the company and are granted options.[25]

Options mut be expensed

One reason for the past popularity of stock options was that companies were not required to report stock options as an expense. However, a new accounting rule now requires that stock options be reported as an expense. As a result, many companies have reduced their stock option grants. The National Center for Employee Ownership reports that 34 percent of publicly traded companies have discontinued their programs.[26]

A Discrepancy between Research and Practice

Recommendation: Use bonus-based PFP not tied to base pay

With regard to actual *pay* for performance, another strong trend today is a **bonus-based** PFP system in which the performance-based pay is not permanently tied to an employee's base pay. In fact, experts have been recommending this approach for years, mainly because the size of the bonus that can be offered can be greater and the cost to the organization in the long run is far less since the bonus is a one-time amount that does not increase your yearly salary.[27] Compensation experts maintain that base pay should be tied to expected levels of work and that PFP should be tied to performance that exceeds that level. Workers are more likely to exceed that level if the performance–outcome connection is stronger and the reward is greater. This connection is typically stronger with bonus-based systems. A growing number of companies now pay lump sums based on corporate or division profits, and the lump sum does not increase an employee's base salary (base pay is typically adjusted based on cost-of-living figures and surveys of competitors' pay). Champion International pays managers based on growth in earnings per share of stock relative to the stock of the 10 major competitors. The bonus awarded to senior managers is not tied to the managers' base pay.

Many organizations use bonuses as part of a **"behavioral encouragement plan"** where employees get payments for specific accomplishments such as safety compliance or attendance. Taco Bell gives biannual bonuses based on an assessment of customer service by a market research company. Other bonuses are granted to store managers for store sales and target profit levels.

Federal Express managers have "small spot" awards of $100 that are available for unusual achievement. For example, one "small spot" award was given to a driver who went well beyond the call of duty to deliver a package when the weather would have been a justifiable excuse. Home Depot has a holiday, bonus-based system available to all employees and awards deep discounts on Home Depot products.

The long-term costs of PFP systems that are tied into base pay can be enormous. For example, the state of Florida awarded $5,000 increases to the base pay of 797 faculty based on the quality and quantity of undergraduate teaching they had performed up to 3 years earlier. The conservative amortized cost of the 797 $5,000 awards was $148.2 million over 20 years. Remember, this was for work already performed. No evidence has ever been presented that the program actually increased either the quality or the quantity of undergraduate teaching. Many of these outstanding professors no longer teach at all but still get over $5,000 per year for great teaching they did 10 (or more) years earlier!

Should You Use Individual, Group, or Company-Level PFP?

As discussed in Chapter 7, among the major issues in performance measurement are the extent to which output is controlled at the group or individual level, whether individual contributions can be measured, and the extent to which important teamwork among unit members would be affected by the PFP system.

At Champion International, for example, earnings are compared only to the company's major competitors so as to control for factors beyond the influence of the managers, such as inflation, interest rates, and general state of the economy. Managers perceive this relative comparison to be fairer than comparisons to absolute earnings, which are more susceptible to changes in the general state of the economy. (Recall the discussion earlier of constraints on performance and the importance of perceived constraints on the critical probability statements in expectancy/instrumentality theory: If I believe factors beyond my control have more to do with performance outcomes than do my own efforts, my motivation to try harder will diminish.) In general, **PFP systems are more effective when specific worker contributions can be clearly measured.** If individual contributions cannot be measured reliably, then the smallest number of workers whose performance is determined to be important (e.g., related to strategic objectives) and, of course, measurable would constitute the incentive group or unit.

Measure and reward individual peformance if possible

An organization may choose to use a group plan even when it is possible to measure output on an individual basis. Individual PFP plans can increase competition among workers and may reduce cooperation and teamwork. As two experts put it, "when companies change the dynamics of work from structure-driven—organized around individual role and functions—to process-driven—often organized around teams—they should change the reward system to support those new dynamics."[28] Workers will be less likely to assist their co-workers if such an effort will adversely affect their own production rate or potential rewards. **If teamwork and cooperation are important, but team members are competing for a set number or amount of awards, a group or unit-based system is preferable.** One health care products manufacturer designed its work teams around project teams for 50 product development employees. But they maintained their old compensation system with job classes, individual performance appraisal, and merit pay. The compensation system turned out to be dysfunctional for the new project-based job structure.

Individual PFP can reduce teamwork

When Should Team-Based PFP Be Used?

A growing number of organizations now use some form of team bonus. One survey of Fortune 1,000 companies found that 70 percent of companies now use some form of team bonus with 17 percent of these organizations applying bonuses to at least 40 percent of their employees.[29]

Team-based pay as part of team-based model

Team-based PFP is a better approach when it is part of a comprehensive team-based model of HRM and compensation. For starters, the job evaluation process would place more emphasis on the work products of the team with less emphasis on individual job descriptions. The focus of the pay structure in general is on objectives and results *of the team.* The performance appraisal and career development systems also focus on team performance and contributing to team performance by new skill acquisition. The performance appraisal system usually includes peer assessment, and great weight is given to the extent to which employees contribute to team performance. (These individual assessments, however, are usually used only as developmental tools and not directly tied to pay.) All forms of reward and recognition programs place emphasis on the team. Company-wide recognition programs focus on team performance and team contribution to the company's strategic goals. Reactions to team-based approaches depend on individual team-member characteristics. One study found that people who are more collectivist in their orientation (high on the "Agreeableness" factor of the Big Five, for example) tend to prefer team-based rewards.[30]

Some individuals prefer team-based pay

There are many examples of individually based PFP systems even where teamwork is critical. Great professional athletes are always paid a premium for their greatness despite the need for teamwork. One point in contrast though—Peyton Manning, star quarterback for the Indianapolis Colts, gave up some of his salary so that the team could afford to compete for free agents. He would have become the highest paid football player in the 2011–2012 season. Clearly, this is an example of someone emphasizing the importance of "team."

Remember, the critical issues regarding the level of aggregation of the performance measures (individual, group, organization) are identifying and measuring performance criteria that the organization seeks to increase or improve in its strategic plan and then linking pay to performance on those measurements. When the pool of award or merit money is not fixed or set among team members, **combining individual and group systems may be the most motivating.** One review summed it up this way: "Both individual and group-based pay plans have potential limitations. Individual-based plans may generate too little cooperation

"Free-rider" issues with team PFP

when work is highly interdependent and may be seen as unfair when system factors rather than individual effort and ability determine performance. In contrast, group-based plans can weaken incentive effects via **'free-rider'** problems, which generally increase with group size. **'Free riders' are workers who benefit from group-based awards but who don't do their share of the work.** You may be familiar with this concept from teams you have worked on during your academic program. Group-based plans can also result in detrimental sorting effects if high achievers go elsewhere to have their individual contributions recognized and rewarded."[31]

Now that the major factors have been introduced that should be considered in designing a PFP system, let's look at the individual, group, and company-based systems in some detail.

INDIVIDUAL PFP PLANS: MERIT PAY AND INCENTIVE SYSTEMS

Individual PFP systems can be divided into merit pay systems and incentive systems specifically tied to production rates. **Merit pay plans** are the most common and perhaps the most troublesome of PFP systems because performance is typically measured by ratings done by supervisors. **Incentive plans** rely on some countable results to be used as a basis for setting the PFP rate. These are also known as *piece-rate* systems. **Sales incentive plans** set certain commissions for sales of specified products or services. Each of these methods is examined next.

What Are Merit Pay Plans?

Merit pay plans call for a distribution of pay based on an appraisal of a worker's performance. Such plans usually result in an increase to the base pay of an employee and is usually granted as a percentage of a worker's base pay. It is the most common PFP program and used in about 90 percent of U.S. firms. Typically, many managerial and professional employees are covered by merit pay plans. At the Tribune Company, for example, 4 percent merit money was distributed to individual units (e.g., TV and radio stations and newspapers owned by Tribune). Unit heads then distributed 4 percent to department heads, who had a total pool of 4 percent of their payroll to distribute among the workers. Obviously, the bigger the pool of meritorious workers, the smaller the average percentage that could be granted.

Surveys indicate that workers prefer merit pay plans that link individual performance with desired outcomes. At least compared to straight pay with no tie-in to performance, workers in general prefer merit pay plans even after they've been granted what they regarded as less than satisfactory raises based on the plan. But some studies have found little relationship between merit pay plans that rely on performance appraisals by supervisors to measure performance and important organizational outcomes, such as productivity increases or cost reductions.

Review again the reasons for failure of PFP systems in Figure 11-4, and you will see that many of these reasons are unfortunately characteristic of merit pay systems. The most serious problem is the failure to create a clear linkage between employee performance and pay. The performance appraisal system and the evaluators of performance are mainly responsible for this problem. There are several factors related to the appraisal system that contribute to this breakdown in the linkage between pay and performance. The fundamental problem is with *measuring* performance, a problem compounded in service industries in which individual performance is more difficult to measure.

Fundamental merit pay problem: measuring performance

An important cause of the measurement problem is the lack of skill of those who do the appraisals. As discussed in Chapter 7, this lack of skill is often manifested in central tendency bias (not using the low or high ends of the rating scale) or more typical, ***leniency bias*** (giving overly favorable ratings). Both of these biases make it difficult for differentiation among employees to exist, which makes it hard to figure out who should get the larger or smaller merit increases.

Rater characteristics

Research has established that rater characteristics, including their personality traits, can predict the average rating raters give across all people whom they rate. Rater "discomfort," defined as the extent to which a person feels uncomfortable giving negative feedback and measured by the **Performance Appraisal Discomfort Scale (PADS),** has been shown to be correlated with the average rating level given by the rater (i.e., higher discomfort is related to more lenient ratings). Also, a rater with a low "Conscientiousness" score (from the Five-Factor Model discussed in Chapter 6) combined with a high "Agreeableness" score will tend to inflate ratings. Recent research shows incremental validity for the prediction of rater leniency using all three rater characteristics (low rater Conscientiousness + high rater Agreeableness + high rater Discomfort = highest leniency levels). The good news is that raters can be trained to reduce their levels of discomfort, which does then reduce leniency.

Raters can be trained to be more accurate

Even raters who do not fit the preceding personality profile will inflate ratings over time if they feel the merit money is being distributed to work units as a consequence of the rater's average ratings (higher ratings by the supervisor get the supervisor more merit money to distribute). The results of this systemwide rating inflation are twofold: (1) a merit pay system in which the amount of the merit pay is relatively trivial because so many individuals are judged to be eligible and (2) a system in which the best performers perceive their merit pay as a gross inequity because the system is supposed to be based on merit.

High turnover among best performers

Use countable outcomes if possible

Research shows high turnover among the best performers when these performers can clearly discern real performance differences (because of actual true differences in countable results) but they nevertheless receive only token merit increases because of chronic rating leniency in supervisory ratings for everyone. The implication of this research is clear. If there is an important countable outcome, develop a PFP system that establishes rewards based on *outcome* differences, not ratings. Otherwise, the best performers will seek out an organization that provides abundant rewards for high levels of performance.

Avoid forced-distribution

One popular approach to dealing with leniency is to impose a **forced-distribution rating** or ranking system in which the number of people rated at the highest level is controlled. For example, General Electric has continued to use forced distribution systems. In general, raters tend to dislike using this system. Microsoft dropped its forced-distribution system in 2008 after numerous complaints by managers who were "forced" to comply with the rating level distributions. Also, the workers felt the system promoted unhealthy competition within work units that relied on collaboration and teamwork to function most effectively. Ford and Pfizer also had problems with employee morale when forced distributions were used causing them to modify what they use. One study conducted by pay guru Ed Lawler found negative results for forced-distribution systems. He reasoned that "when employees in a work area compete with each other for ratings, knowing there is always a percentage at the bottom who will be forced out, it creates fear and selfishness. People are much less likely to help each other, train each other, share information, and operate as an effective team. In today's flatter, knowledge work–driven, more team-based organizations, excessive internal competition can take a significant toll on organizational performance."[32]

Many quality improvement experts maintain that pay should not be linked to performance, particularly at the individual level. Deming, the most highly regarded of the quality gurus before he died in 1995, believed that performance appraisal fostered competition among individual workers and diverted attention away from the *systems* related to the quality of the product or service. Despite Deming's comments, most individuals prefer to be paid on the basis of some measure of their own performance. The problem is creating the linkage when the criteria are ambiguous. The merit pay principle is easy when criteria are available that are countable (not rated by supervisors) and important (linked to the strategic plan of the organization or unit or to specific customer requirements). Although most jobs do not easily provide objective criteria, and firms thus rely on ratings, alternatives to supervisory ratings are available. As discussed in Chapter 7, ratings by internal and external customers on the extent to which their expectations are met could be a preferable alternative to supervisory ratings. Studies have found that including some measure of customer satisfaction as one of the outcome measures has a positive effect on sales, profits, and subsequent customer satisfaction.[33] Federal Express conducts customer-related performance reviews every 6 months.

Although they have problems, merit pay systems are still widely used. In fact, over 90 percent of the Malcolm Baldrige Award winners for quality still use it as their primary

Figure 11-5
Recommendations for Merit Pay Plans

1. Use a bonus system in which merit pay is not tied to the base salary.
2. Maintain a bonus range from 0 to 20 percent for lower pay levels and from 0 to 40 percent for higher levels.
3. Pay attention to the process issues of the merit pay plan. Involve workers in decision-making and maintain an open communication policy.
4. Take performance appraisal seriously. Hold raters accountable for their appraisals, and provide training.
5. Focus on key organizational factors that affect the pay system. Information systems and job designs must be compatible with the performance measurement system.
6. Include group and team performance in evaluation. Evaluate team performance where appropriate, and base part of individual merit pay on the team evaluation. Use multiple rates if possible.
7. Consider special awards separately from an annual merit allocation that recognizes major accomplishments.

Source: Adapted from E. E. Lawler, "Recommendations for Merit Pay Plans," *Strategic Pay,* San Francisco, CA. Copyright © 1990. Reprinted by permission of John Wiley & Sons Inc.

tool for rewarding performance. In general, merit ratings have been shown to be related to probabilities of promotion, and most research indicates that merit pay can positively impact performance. In addition to the recommendations presented in Chapter 7 for sound performance appraisal systems, Figure 11-5 presents a set of recommendations for the use of individual merit pay systems. Organizations should strive to follow these prescriptions.

What Is Incentive Pay?

Piece-rate pay

Incentive pay is based on units produced and provides the closest connection between individual effort or performance and individual pay. There are two types of individual incentive systems based on nonrated output: the **piece-rate system** and the **standard hourly rate.** Many variations of piece work have been used over the years, but most share common characteristics. A firm using the piece-rate system will determine an appropriate amount of work to be accomplished in a set period (e.g., an hour) and then define this as the standard. (Recall from the discussion in Chapter 4 that job analysis methods can be used to establish work standards.) Then, using either internal or external measures, a fair rate is set for this period. The piece rate is then calculated by dividing the base wage by the standard. Today, to comply with regulations such as the minimum wage, piece-rate plans should include an hourly wage and a piece-rate incentive.

The basic piece rate is the oldest and most common wage incentive plan. The oldest approach, popular in textile and apparel mills, is called ***straight piece work.*** With this approach, a worker is paid per unit of production with no base pay. Used in early American times when work was done at home, the straight piece-rate approach is still popular, particularly with the increased use of electronic monitoring of performance. Data processing personnel, customer service representatives, and some clerks, for example, are paid based on a specific formula tied to the finished product or the number of customers served or processed. In general, if individual performance can be accurately measured and teamwork or worker collaboration is not important for the desired performance outcomes, a piece-rate approach is the recommended approach. However, a stable, base hourly wage is recommended along with the piece-rate incentives.

International Piece-Rate Pay

The piece-rate pay method is also very common in factories around the world, particularly in textile factories where (typically) young women are paid by the piece of clothing produced. Nike, Ralph Lauren, Liz Claiborne, and Tommy Hilfiger maintain that the hourly rate they pay with the piece-rate system complies with the minimum wage laws of the host country. For example, in 2012 Nike paid the following wages in *full compliance with the minimum wage requirements of the respective countries:* 20 cents an hour in Vietnam; 30 cents an hour in Haiti; and 54 cents an hour in Indonesia. According to Medea Benjamin of Global Exchange, a San Francisco world labor watchdog group, these hourly rates do not even get the employees three decent meals a day. Nike, Liz Claiborne, Reebok, and numerous other companies signed on to a "Code of Conduct" of the Fair Labor Association that put some controls on the pay and treatment of international workers. With regard to

Minimum wage of the host country

wages, however, compliance with the minimum wage laws of the host country is all that is stipulated.

The basic piece rate provides a production incentive based on paying only for what is actually produced. A simple piece-rate approach often results in production variability that can disrupt the flow of product to customers. **Production variability** occurs because employees may be willing to forgo extra effort on some days when they are tired, bored, or ill but will work especially hard on other days when they need some extra money. Frederick Taylor developed the **differential rate** as a response to the variation potential in piece-rate systems.[34] Taylor's differential rate had two piece rates: one for performing below standard and a higher rate for meeting or exceeding the standard, thus encouraging workers to at least meet the standard. One major advantage of piece-rate systems is that they are easy to understand. They are useful in labor-intensive industries such as textiles or agriculture, where individual production can be reliably measured. Migrant workers who harvest fruit and vegetables are often paid by unit of production.

Lincoln Electric, a Fortune 500 Ohio company, is cited as *the* success story regarding piece-rate pay. In fact, Stanford's Jeff Pfeffer considers Lincoln to be one of corporate America's greatest success stories, citing Lincoln's piece-rate system as a primary reason for its success. However, Dr. Pfeffer is careful to clarify that " although the factory workforce is paid on a piecework basis, it is paid only for good pieces—correct quality problems on their own time. Additionally, piecework is only a part of the employees' compensation. Bonuses, which often constitute 100 percent of regular salary, are based on the company's profitability."[35]

When does piece-rate work best?

Except for some industries like textiles, individual piece-rate systems are less popular now than they were 20 years ago as a growing number of jobs are team based or are in areas such as the service sector, which often precludes the establishment of a clear standard for determining the rate of production and the piece rate. **Piece-rate incentive systems tend to work better when the situation is repetitive, the pace is under the direct control of individual workers, there is little or no interaction or cooperation required among workers, and the results can be easily measured or counted.** But even for companies in which incentive systems would seem to work, there can be trouble. The major problem with incentive systems is that an adversarial relationship can develop between workers and management. Workers make every effort to maximize their financial gains by attempting to manipulate the system of setting rates, setting informal production norms, and filing grievances regarding rate adjustments. Lincoln Electric, for example, had great difficulty implementing a piece-rate system in some of its international plants when it expanded in the 1990s. Plants in Germany and Brazil were ultimately shut down. The highly acclaimed management system apparently does not automatically transfer across the world.

There are numerous examples of worker attempts to sabotage piece-rate incentive systems. One expert on pay systems tells the story of how a sales force selling baby foods in South Florida kept secret their highly successful efforts at selling the food to senior citizens because they feared that their method would be rejected by management.[36]

Unfortunately, many jobs outside of sales and straight assembly work do not have a reliable measure of production or performance. Another problem is that adjustments in the standard are required whenever there is a significant change in the machinery or production methods. Finally, work group norms can develop that will restrict the productivity of any one individual. Employees may worry that high earnings under the PFP system will result in an adjustment of the standard. Also, some workers may worry that high productivity may translate into terminations if inventories get too large.

Some banks have piece-rate systems for data entry jobs in which individuals entering check amounts have virtually no interaction with co-workers. Workers control the rate of data entry, and the computer tallies the rate of production. One bank reported a 30 percent increase in production after installing a piece-rate system for data entry personnel.[37] Many customer service reps whose performance is closely monitored by computer are also paid by piece rate.

Potential problems

The adversarial relationship that can develop between workers and management regarding a piece-rate system can be reduced or eliminated if workers participate in the rate-setting process through task forces. Says one expert, "If they do not involve employees, there is a good chance that the employees will find a way to get involved—for example, by organizing a union."[38] Despite these cautionary notes, **piece-rate incentive systems can be very effective when there is good trust between workers and managers.**

Standard Hourly Rates

Standard hourly rates differ from piece-rate systems in that the production standard is expressed in time units. Using job analysis, the standard time for a given task is established and the organization then sets a fair hourly wage rate. The standard rate for any task is the wage rate times the standard. For example, if the standard time for a task is 4 hours and the fair hourly wage is $10, the standard rate is $40. The worker receives the $40 standard rate of pay regardless of the length of time it takes to complete the task. A common example is auto body repair. A customer is given an estimate based on a standards book listing the time required to repair various parts of a car and the hourly wage rate. Insurance companies use a similar book to check the accuracy of the estimate.

In some standard hourly plans, the rate varies with output. For example, the **Halsey plan,**[39] developed in 1891 by Frederick Halsey, divided between employer and worker the savings realized from performing a task in less than the standard time. Halsey believed that sharing the rewards with management would reduce the likelihood that management would increase the standard as worker output increased. Although Halsey proposed a one-third worker and two-thirds organization split, today his plan is more commonly known as the **"Halsey 50-50 plan,"** because savings are equally divided.

Bottom-Line on Incentive Systems

When managers are considering an incentive system, they must take into account the firm's organizational strategy, culture, and position in the marketplace. Incentive plans in manufacturing are advisable if there are (1) high labor costs, (2) a high level of cost competition in the marketplace, (3) relatively slow advances in technology, (4) a high level of trust and cooperation between labor and management, and (5) individuals can control or affect the rate of production.[40]

The loss of U.S. jobs most conducive to individual incentive systems, particularly in manufacturing, combined with the trend toward more team-based work systems, indicates that the decline in individual incentive systems in the United States based on rates of production may continue. The only exception may be in the area of education where there is a trend toward paying (and retaining) individual teachers based on the academic performance of their students.

What Are Sales Incentive Plans?

Performance-based sales incentive plans have been found to increase sales over time.[41] Sales incentive plans share many of the characteristics of individual incentive plans, but there are also unique requirements. Both the determinants of employee control over output and measurability of performance have added dimensions for sales. Because an output measure can be easily established as the level of sales, in dollars or units, a common assumption is that salespeople are paid strictly on the volume of product sold. In many cases, however, employers expect salespeople to perform duties beyond strictly sales. Like any PFP system for a job with many important performance dimensions, if sales duties include customer training, market analysis, and credit checks, then the PFP system should involve complex measures of performance that include these dimensions along with sales data. Thus, a critical first step for a sales incentive program, as for all other incentive programs, is to determine what aspects of performance are most important to the firm. The next step is to decide on the methods of measurement and the appropriate levels of compensation. To motivate employees to increase customer satisfaction, many companies now incorporate client or customer-based survey results into their sales compensation systems to underscore the need for nurturing customer relations as well as selling products and services.[42]

Approximately 75 percent of salespeople are on a commission-based, incentive plan.[43] **Commission plans** pay the salesperson directly on sales data. Although simple in concept, commissions can become complex. Ordinarily, commissions are a percentage of the dollar value of sales. However, the percentage can increase, decrease, or be constant in relation to changes in sales volume, depending on the nature of the product and its market. Commissions should provide sufficient incentive to the salesperson without adding too much to product cost. Because commissions can be highly variable over time, some firms protect salespeople from low sales periods by using a **draw-plus commission system.** At JCPenney, for example, a salesperson can draw against an account up to a predetermined limit during slack periods. During periods of higher commissions, the draw account is repaid from commissions in excess of the draw limit. A draw is essentially an interest-free loan to the salesperson, repayable when commissions exceed the draw limit. Another common sales incentive plan uses commissions in conjunction with a base salary. The base salary serves as a guaranteed minimum wage, and the commissions are an incentive to sell. Inclusion of salary as part of compensation is useful when the firm requires the salesperson to perform activities other than sales.

Many variations of sales compensation exist. Bonuses for a specific product and bonuses for sales levels are common. In each case, the reward should be tied to a specific performance criterion that is of value to the firm and that justifies the additional expense. Sales incentive programs may have equity problems that differ from a manufacturing situation. Operators of similar machines face the same workplace challenge, but salespeople with different territories may experience different levels of opportunity and challenge.

Most companies now have databases that enable them to establish and sustain a fair sales incentive program through the maintenance of the sales history of particular territories. For example, Steelcase offers greater incentives for new business in low-volume territories where their analysis indicates greater competition. Information systems now provide more sophisticated incentive systems that can promote equity among the sales force.

Stockbrokers often receive a large percentage of their pay based on commissions from stocks. This situation is considered the underlying cause of litigation by brokers' customers who claim that this conflict of interest led to brokers pushing poor stocks that paid high commissions. As discussed earlier, the national mortgage crisis can also be partly blamed on a flawed commission-based incentive system for mortgage brokers.

Alternatives to cash

Many companies now offer rewards other than money as recognition for sales performance. Trips and prizes, which can be purchased by the company at a price considerably less than the cost of cash-only incentive programs, are quite common as a form of sales commission today, particularly in insurance, real estate, and the tourism industry. JM Family Enterprises provides trips to the Bahamas on the company yacht, haircuts, and massages as part of its awards system for top performers.

What Are Bonuses?

Bonuses are more effective than base-pay adjustments

Bonuses are one-time payments based on performance. They have the advantage of not adding permanently to the base wage and can be given based on either rated or nonrated output measures. Bonuses also can be based on individual or group-based measures. Some workers prefer them to merit pay plans because they get the money all at once and it looks like a larger sum. Fifty dollars every 2 weeks does not have the same impact as a single payment of $1,300. In general, bonuses are more effective because they allow for larger one-time awards without the amortized effect of tying pay for performance into base pay. Bonuses are often used for meeting performance expectations and, in some cases, are also used for joining a firm (e.g., signing bonus).

WHAT ARE GROUP INCENTIVE PLANS?

There are three major types of group-based incentive plans: **profit-sharing, gainsharing,** and **employee stock option plans.** Profit sharing distributes a portion of corporate profits among designated employees. Gain sharing divides a portion of cost reductions or productivity increases between groups covered by the plan. Stock option plans distribute stocks and stock options to employees based on corporate performance measures such as return on equity.

All three types are designed to establish a link between pay and performance, but performance is measured at the group, unit, or company level. Many PFP systems combine individual PFP systems with some form of group incentives. Recall the discussion of Lincoln Electric, where the piece-rate method is combined with profit sharing for all employees.

In general, as **expectancy/instrumentality theory** would predict (see Figure 11-3) group-based systems are at least theoretically less motivating because individual employees typically do not perceive a strong connection between their individual efforts and performance. The use of all three of the group plans have increased in the last few years, and the majority of gainsharing plans in the United States were introduced in the past 25 years. Manufacturing organizations are more likely to adopt group plans than are service-oriented firms. Group plans are generally preferable to individual plans under the popular team-based approaches to production or service, although, as discussed in Chapter 7, this depends principally on the ability (or inability) to sort out individual contributions to important outcomes.

Group plans are best when cooperation and teamwork are essential

Successful group incentive plans require the same determinants as individual plans. The measures differ in that a group plan must be based on a measure of group performance or productivity. The use of group plans is particularly effective when cooperation and teamwork are essential and when a goal of the system is to enhance the feeling of participation. Group plans are most useful when tasks are so interrelated that it is difficult (or impossible) to identify a measure of individual output. The size of the "group" can range from two people to plantwide or companywide. The smaller the group, the more a worker will identify his or her individual effort as affecting the group's performance.

FLSA compliance

Group PFP plans require special considerations. First, because of the "free-rider" effect, there is potential for conflict when all group members receive the same reward regardless of individual input. Second, strong group norms that control output can inhibit group efforts. Third, the variable compensation distribution formula must meet the **Fair Labor Standards Act** requirements for calculating for wages and overtime pay.[44] While these three issues can complicate matters, there is nonetheless strong evidence that group incentives can increase productivity.[45]

What Is Profit Sharing?

Profit sharing is designed to motivate cost savings by allowing workers to share in benefits of increased profits. Generally, profit-sharing plans pay out when employees meet a profitability target such as return on assets or net income. As discussed in Chapter 10, retirement income for employees is frequently linked to a profit-sharing plan. Rewards can be periodic cash disbursements or deposits to an employee account. Either a predetermined percentage of profit or a percentage above a certain threshold is allocated to a pool (e.g., 10 to 25 percent). This pool is disbursed to employees on the basis of some ratio, usually related to their wage. Many companies now have options from which the employee may select a particular profit-sharing plan compatible with his or her long-range plans. Profit sharing has been criticized as being remote and perceptually unrelated to individual performance, but research indicates that it produces generally positive results.

Controlling turnover

Group size should be small

Many firms also use profit sharing as a tool to control employee turnover. At Johnson & Johnson, the allocation is distributed in equal increments over a period of years, and an employee sacrifices the remaining distributions by leaving the firm before the period is up. Obviously, some of the incentive value of profit sharing for higher performance is lost when it is used in this fashion. In general, profit sharing works best as an incentive when the group size is small enough that employees believe they have some impact on group profitability.

The typical profit-sharing plan uses profits to fund retirement plans and is thus advantageous for tax purposes. However, some companies pay annual bonuses based on company profits. Anderson Windows, for example, has a profit-sharing pool that has paid employees up to 84 percent of their annual salary. This approach gives Anderson greater flexibility during hard times since company costs go down when company performance goes down. Given the relatively lower base pay for its employees, Anderson was able to retain most of its employees in 2008 despite a significant downturn in business.

While employees generally approve of profit sharing, they get testy when their base pay is affected in a negative way by profit-sharing provisions. When DuPont Corporation announced that there would be 4 percent cuts in the base pay of all its 20,000 employees due to poor sales in the fibers division, worker dissatisfaction was so high that the profit-sharing plan was scrapped. If the company was profitable, workers would have earned an additional 12 percent above their base pay under the plan. The major reason for the dissatisfaction with the system was the lack of perceived connection between worker performance and company profits. UAW workers at Caterpillar struck the company partially because they wanted an increase in base salary and a decrease in the risk of the profit-sharing plan.

Profit sharing can be seen as a way to align the goals of management and employees. When employees perceive profit sharing favorably, commitment to the organization and trust in management tend to increase, thus "encouraging employees to exert maximum effort, share information, and invest in firm-specific training that may not be valued outside the firm."[46] Studies have reported increases in productivity between 7 and 9 percent. However, workers' beliefs that they have sufficient control to contribute to the profitability of the organization are critical to the success of profit-sharing programs.

Productivity increases between 7 and 9 percent

One study concluded that "when profit sharing is perceived as both an opportunity for individual input to the organization's success and a reflection of the organization's desire to treat employees fairly, higher levels of commitment follow. Structuring profit-sharing systems to enhance perceptions of input (e.g., some portion of the profit sharing based on individual contribution to performance) and reciprocity (e.g., some portion based on years of service) appears to be advantageous."[47]

Profit-sharing for performance and seniority

What Is Gainsharing?

Gainsharing (also known as Gain Sharing) is a group incentive system that gives participating employees an incentive allocation based on improved performance. Performance can be defined by increased productivity, lower costs, improved safety measures, or customer satisfaction indexes. Gainsharing bonuses are typically given on a monthly basis, and the range in bonus pay is between 5 and 10 percent of base pay. Effective gainsharing programs are based on a formula derived with worker input and which workers perceive as fair.

Gainsharing is a popular approach to motivate higher levels of group productivity. While there are subtle differences among various PFP programs classified as "gainsharing," all of them essentially involve worker involvement and the process of sharing in the financial benefits of reducing costs or increasing productivity. One survey found that gainsharing is the second most important compensation topic among human resource managers.[48]

Worker involvement is critical

More gainsharing plans were instituted in the mid-1980s than in the previous 50 years,[49] and almost 40 percent of Fortune 1,000 manufacturing firms rely on some form of gain sharing.[50] Gainsharing plans either try to reduce the amount of labor required for a given level of output (cost saving) or increase the output for a given amount of labor (productivity increase), or both. The method for determining the standard production rate and the incentive rate must be clearly defined. Gainsharing plans generally are based on the assumption that better cooperation among workers and between workers and managers will result in greater effectiveness. Successful plans require an **organizational climate** characterized by trust across organizational levels, worker participation, and cooperative unions. An organized **employee suggestion system** is also characteristic of almost all gain-sharing plans. To maximize cost-saving and productivity increases, there must be employee involvement in the plan development and execution. A successful gainsharing plan requires workers and management to work toward a common goal. Gain sharing encounters difficulty when management downgrades employee input or unions adopt a strong adversarial position. Like profit sharing, instrumentality can be low since employees may not perceive a strong connection between their performance and desired outcomes.

Cooperation and trust are critical

Gainsharing plans can get complicated. Measures of productivity are usually adapted to particular situations. For example, one firm uses both the labor/sales ratio and the cost-of-quality/sales ratio as financial measures. Another firm uses savings on warranty costs as a measure for its engineers and designers. As one expert puts it, "The financial measures of performance have great educational value in spurring employee understanding of business fundamentals . . . financial measures tend to closely parallel overall firm performance."[51]

Financial measures parallel firm performance

Most types of gainsharing plans use a productivity ratio to capture labor's contribution to value added. The differences among the plans concern how labor's cost is calculated for the numerator and how organizational output is measured for the denominator.

Gainsharing plans are different from profit sharing in two major ways.

1. Gainsharing is based on a measure of productivity, not profit.
2. Gainsharing rewards are given out frequently, whereas profit sharing is annual and often tied to a retirement plan as deferred payment.

What Are the Four Approaches to Gainsharing?

There are four basic approaches to gainsharing, although there is considerable variation within them. The four approaches are the **Scanlon plan,** the **Rucker plan,** the **IMPROSHARE plan,** and **Winsharing.** In addition to the productivity ratio, other issues influence the selection of a gainsharing plan. One of the most important aspects of a PFP system, strength of reinforcement, is roughly equal for the four methods. A summary of the issues to be considered in selecting a plan is provided in Figure 11-6.

The **Scanlon plan,** the most common gainsharing plan, measures the relationship between the sales value of production and labor costs. Like all gainsharing options, employee participation is an important component of this approach. Screening committees are used to evaluate cost-saving suggestions from employees with labor cost savings serving as the incentive. Savings are measured by a monthly calculation of the ratio of payroll-to-sales value of production compared to baseline data.

The Scanlon plan is the oldest form of gainsharing.[52] Developed by Joseph Scanlon, a steelworker, a union official, and later a professor at the Massachusetts Institute of Technology, the plan was originally devised to keep the La Pointe Steel Company from going bankrupt. The plan received wide public attention because of a *Life* magazine article published in 1946. At the time, its unique aspects were (1) rewarding the group for suggestions by individuals in the group; (2) joint labor–management committees designed to propose and evaluate labor-saving suggestions; and (3) a worker reward share based on reduced costs, not increased profits.

Scanlon plans require a considerable commitment by workers and management to cooperate in the development and maintenance of the program. While the track record for Scanlon plans is mixed, there are some great success stories. One paint manufacturer in Texas reported a 78 percent increase in production over its 17-year history of using a Scanlon plan.[53] The keys seem to be employee trust, understanding, and contributions to improvements. For example, one expert attributed the Scanlon plan's success this way: "A formal method for having all organizational members contribute ingenuity and brainpower to the improvement of organizational performance . . . and improvement of relations across functional groups and levels of the organizational hierarchy."[54]

The **Rucker plan** is another successful group incentive system. While similar to Scanlon, the Rucker formula includes the value of all supplies, materials, and services. The result is a bonus formula based on the value added to the product per labor dollar. Thus, an incentive is created to save on all inputs, including materials and supplies. The advantage of Rucker over Scanlon is the linkage of rewards to savings other than labor savings, plus greater flexibility. The disadvantage is that concepts such as value added and the adjustments for inflation make the Rucker plan more difficult to understand and explain compared to the Scanlon plan.

Figure 11-6
Factors to Consider in Designing a Gainsharing Program

1. **Performance and financial measures.** The bonus formula must be perceived as reasonable, accurate, and equitable.
2. **Plant or facility size.** Plants with fewer than 500 employees are ideally suited to gain sharing, while plants with over 2,000 employees are not.
3. **Types of production.** Plants with highly mixed types of production will find it difficult to introduce gain sharing because the measurement process is so complicated.
4. **Workforce interdependence.** Highly integrated work units are ideal for gain sharing.
5. **Workforce composition.** Some workforces may not be as motivated by financial incentives.
6. **Potential to absorb additional output.** Initial increase in productivity must be useful to the organization and must not entail negative consequences for the workforce (e.g., layoffs).
7. **Potential for employee efforts.** Can employee efforts actually affect productivity to a significant extent, or does automation (or other factors) impede worker effects?
8. **Present organizational climate.** An initial level of trust is required.
9. **Union–management relations.** Union should be an active partner in program development.
10. **Capital investment plans.** Don't install gain sharing if large capital investments are planned.
11. **Organized employee suggestion system.** Do not downgrade or ignore employee input.

Source: Reprinted from "Gain Sharing: Do It Rights the First Time," by M. Schuster, MIT *Sloan Management Review*, Winter 1987, pp. 17–25, by permission of the publisher. Distributed by Tribune Media Services.

IMPROSHARE

A third category of gainsharing is **IMPROSHARE,** which stands for "improved productivity through sharing."[55] IMPROSHARE is similar to Scanlon except that the IMPROSHARE ratio uses standard hours rather than labor costs. Engineering studies or past performance data are used to specify the standard number of hours required to produce a base production level. Savings in hours result in reward allocation to workers. IMPROSHARE "rewards all covered employees equally whenever the actual number of labor hours used to produce output in the current week or month is less than the estimated number it would have taken to produce the current level of output in the base period."[56] IMPROSHARE is easy to administer, and employees have no difficulty understanding the formula.

Winsharing combines gainsharing with profit sharing.[57] Winsharing is based on the rational proposition that if your PFP system results in more product being produced than cannot be sold, your PFP system needs some alterations. Winsharing takes market demand into consideration. Winsharing payouts are based on whether group performance is achieved relative to business goals. Financial performance in excess of the goals is split evenly between workers and the company. Winsharing differs from profit sharing because group performance measures are used that are independent of profit measures.

What's the Bottom Line on Gainsharing?

Research has found numerous benefits from gainsharing plans, including improved productivity and quality.[58] The strong trend is to use some form of gainsharing with other approaches to improving productivity and performance.[59] Kendall-Futuro, a health care products company, improved its "just-in-time" performance with gainsharing. At Timken's Faircrest Steel Plant in Canton, Ohio, employees participated in the design of a gainsharing plan that has generated average payouts of over $6,000 a year per worker. The teamwork and cooperation between union workers and management is an essential component of the success of the program.[60] The company reports strong success so far. Other major companies offering gain-sharing plans include Georgia Pacific, Huffy Bicycle, Inland Container, Eaton Corp., TRW, and General Electric.[61] Gainsharing is evolving from a simple productivity concept into a family of measures all designed to improve performance.[62] Whirlpool instituted such a family that featured gainsharing. The board of directors receives stock options when targets are met. Senior managers can receive up to 100 percent of base salary as annual stock options. Whirlpool eliminated profit sharing and instituted **winsharing,** which increased worker performance as well as knowledge about shareholder value.[63]

Union teamwork and cooperation is essential

Success of gainsharing plans in general depends on significant involvement and support by high-level management, actual employee participation and understanding, and realistic employee and (if applicable) union expectations. In addition, gainsharing plans can come under pressure in years where there is no bonus payout. A plant at DuPont's Fibers Division dropped its plan due to this factor.[64]

Companies that are reluctant to involve unions in strategic planning will have difficulty with gainsharing programs. There is also considerable evidence that group size affects gainsharing results. For example, doubling the number of employees covered from 200 to 400 was associated with a 50 percent drop in the average productivity gain.[65]

Group size and results

One review of Scanlon, Rucker, and IMPROSHARE plans concluded that

1. IMPROSHARE is easier for workers to comprehend.
2. With IMPROSHARE workers have more control over physical productivity.
3. IMPROSHARE does not require management to reveal sensitive corporate financial information.

The advantages of Scanlon and Rucker plans over IMPROSHARE are that

1. Workers actually share in the financial risks of the company (appealing to management).
2. The Scanlon plan typically allows for more integration with problem-solving processes.

Support for IMPROSHARE

A well-controlled study of IMPROSHARE found that productivity continues to rise sharply after the initial introduction of the plan for at least 3 years. After 3 years, few gains occur and productivity begins to plateau at the higher level (likely because slack has been eliminated and further changes may require dramatic production process changes).[66]

What Are Employee Stock Option Plans?

As discussed earlier, many companies use employee stock option plans to compensate, retain, and attract employees. These plans are contracts between a company and its employees that give employees the right to buy a specific number of the company's shares at a fixed price within a certain period (usually more than 5 years). Employees who are granted stock options hope to profit by exercising their options at a higher price than when they were granted.

Employee stock option plans should not be confused with the term *"ESOPs," or Employee Stock Ownership Plans,* which are retirement plans (discussed in Chapter 10). An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock to the plan for the benefit of the company's employees. With an ESOP, employees do not buy or hold the stock directly. According to the National Center For Employee Ownership website, as of 2009, 13.6 million employees owned company stock via ESOPs, stock bonus plans, or profit-sharing plans invested in stock. Another 5 million employees held company in stock via 401(K) plans. In addition, 9 million employees participated in broad-based stock option plans, while another 11 million participated in stock purchase plans. In all, about one-third of all private sector employees had some level of ownership in their employing firms.[67]

The Securities and Exchange Commission presents the following example of a stock option plan on its website: An employee is granted the option to purchase 1,000 shares of the company's stock at the current market price of $5 per share (the "grant" price). The employee can exercise the option at $5 per share—typically the exercise price will be equal to the price when the options are granted. Plans allow employees to exercise their options after a certain number of years or when the company's stock reaches a certain price. If the price of the stock increases to $20 per share, for example, the employee may exercise his or her option to buy 1,000 shares at $5 and then sell the stock at the current market price of $20. Stock option plans have often been used to attract and retain employees at companies, particularly high-tech and start-up firms. Microsoft created more than 10,000 millionaires through its original stock option program, although now it uses stock grants instead.[68]

Companies sometimes revalue the price at which the options can be exercised. This may happen, for example, when a company's stock price has fallen below the original exercise price. Companies revalue the exercise price as a way to retain their employees. Many of our nation's largest companies have such option plans for nonmanagerial employees (e.g., Lockheed, JCPenney, Texaco, Procter and Gamble, Avis). In principle, options sound like a terrific idea: Companies sell stock to workers in order to give them a financial stake in the company. Stock allocations are made to the employee's account based on relative base pay. **Research results on the effects of stock options are unclear; however, one review concluded that "few of the studies have found strong and significant effects."**[69] Options tend to work better when combined with extensive employee involvement and problem solving.

A popular method designed to replace fixed compensation costs with variable wages and benefits, options give the organization greater flexibility in response to a competitive environment. Santa Fe Railway reduced employee pay for the first time in the company's 122-year history. The pay cuts were replaced with stock options that resulted in bonus checks for all 2,400 salaried employees. Some employees received checks in excess of $100,000. Needless to say, Santa Fe employees are now very happy with the new incentive system. Behlen Manufacturing has had great success in using a blend of base pay, gainsharing, profit sharing, and options to support its organizational goals. There are also some sad stories indicating that options are no panacea. At Burlington Industries, employees bought out the company only to watch the stock plummet to less than half its purchase value.

Effects of stock options

One review drew the following conclusions and implications for options.[70]

1. Since stock options are distributed differentially in proportion to performance or contribution, they may be perceived as more equitable than profit or gainsharing, particularly by employees seeking some sense of control or ownership in the company.
2. Options might generate weaker levels of work motivation and subsequent performance than other incentive systems as their ultimate value is determined, at least in part, by market forces over which the employee has no control.

3. Consequently, the eventual value (or even anticipated ownership component) of stock options may turn out to be less proportionate to actual employee contributions or performance than expected. The result can be relatively stronger perceptions of inequity and lower instrumentality.

MANAGERIAL AND EXECUTIVE INCENTIVE PAY

"Say on Pay Act"

In a 2011 editorial in the *Harvard Business Review,* it was noted that CEO pay has returned to its prerecession levels and that total pay packages for CEOs at S&P 500 companies rose 28 percent in 2010 to a median of $9 million.[71] This was after 2 years of declines and despite fears regarding the increased governance oversight on executive pay due to the "Say on Pay Act" put into law in early 2011. Base salaries remained flat at $1.1 million, while annual incentive payments increased by 19.7 percent to $2.2 million, yielding a 12.8 percent increase in overall cash compensation at $3.4 million. Also, for the first time in 2 years, long-term incentives grew by 7.3 percent to $6.2 million. According to the *Wall Street Journal*/Hay Group report, these increases were most likely due to stronger company performance since companies in their report achieved a median 17 percent increase in net income and a total shareholder return of 18 percent.[72]

Today, CEO pay is under much greater scrutiny than in the past given the fact that for years executives have been paid unbelievable amounts even when their companies had major losses and really bad financial performance. Nicholas Kristof of the *New York Times* asks, "Are you capable of taking a perfectly good 158-year-old company and turning it into dust? If so, then you may not be earning up to your full potential. You should be raking it in like Richard Fuld, the longtime chief of Lehman Brothers." Fuld took home almost a half a billion dollars in total compensation between 1993 and 2007. He "earned" $45 million or $17,000 an hour in 2007 just before the company went bankrupt.[73] It should be noted, however, that not all executives make these exorbitant salaries. Recent research noted that pay for women executives is 50 percent less in total compensation than their male counterparts, due mostly to differences in performance-based compensation. Specifically, it was found that women do not increase the value of their stock option compensation as much as men, which could be due to discrimination by the male-dominating boards in many companies, fewer attempts by women to negotiate their options, or for other reasons.[74]

In general, executive incentive plans are linked to net income, some measure of return on investment, or total dividends paid. These incentives are paid in the form of bonuses, not permanently tied to base pay, and the awarding of stock options. One trend is the movement away from stock options and toward other long-term awards. This is because executive pay is a hot political issue. Even Warren Buffett has called it "obscene." "It's just way off the charts," says portfolio manager Jennifer Ladd, who is fighting for lower executive pay. Disney CEO Robert Iger recently stated, "clearly executives today are overcompensated for what they deliver short-term and undercompensated for their long-term investment. I'm heavily incentivized to create long-term growth for this company, because I have a long-term incentive plan – stock options and other stock awards that not only vest over time but become available to me over time. Growing the company from now until then is something I'm highly motivated to do. But most companies' compensation plans still favor short-term results."[75] Management guru Peter Drucker argued that no CEO should earn more than 20 times the company's lowest-paid employee. He reasoned that if the CEO took too large a share of the rewards, "it would make a mockery of the contributions of all the other employees in a successful organization."

Unintended consequence of executive PFP: earnings restatements

A large portion of executive compensation is now tied to meeting earnings goals. According to a *Forbes* magazine editorial, "Accepted accounting principles are an art, not a science. Give a smart boss the incentive to do it, and he can push the earnings envelope to the limit—or beyond." Delphi, OfficeMax, Qwest, and WorldCom are companies that heaped big performance-based bonuses on their bosses but subsequently had to restate earnings lower after accounting shenanigans were discovered. Paying for performance "has vastly increased the number of accounting disasters," says Paul Hodgson, a senior research associate at the Corporate Library, a corporate-governance research firm in Portland, Maine. According to a study by the comptroller of New York State, between 1995 and 2002, when companies were increasingly tying bonuses to earnings, the number of earnings restatements increased from 44 to 240.[76]

Are There Documented Negative Consequences to Widening Pay Dispersion?

Pay dispersion can result in turnover of key personnel and lower pay satisfaction

While there has been considerable commentary about the negative consequences of the widening dispersion between CEO pay and the pay of others, little research has shown a relationship between this gap and subsequent performance decrements or higher turnover. The problem of pay dispersion may be more acute in more technologically intensive industries where executives are encouraged to be entrepeneurially aggressive and they often are compensated very well based on their performance. However, intensive teamwork and coordination are often required for the development of high-tech products or services, thus indicating the need for a PFP system with more of a team- or corporate-level orientation. One study found that pay dispersion in high-tech firms is predictive of subsequent performance decrements.[77] A recent study found that the discrepancy between the CEO's pay and that of the "top management team" increased the likelihood that members of the team would leave the organization.[78] Pay dispersion tends to diminish communication, increase status gaps, and foster aggressive competition for advancement to lucrative top posts within a company. One survey of pay satisfaction in a retail environment found significant decreases in pay satisfaction among the rank and file workers after the top management team's pay was made public. Employees also indicated higher rates of intentions to leave the organization, stronger interests in joining a union, and lower levels of organizational commitment and trust. The extent to which the CEO was thought to be overpaid was a strong predictor of these negative outcomes.

Another area that seems to be upsetting to "regular employees" is the amount of company perks given to CEOs. This is an area that has recently been altered due to the economic times. According to the 2010 *Wall Street Journal*/Hay Group study on CEO compensation, 16 percent of the firms indicated that they had eliminated at least one perquisite, such as country club memberships, although using corporate aircrafts remained the most common perk still being used by CEOs.[79]

Should You Use Short- or Long-Term Measures of Performance?

A principal distinction between managerial and executive incentives is the time horizon of the performance measure that is the basis of the incentive. Although many lower-level managers are being awarded stock options, they often have incentives based on short-term measures. As discussed earlier, these short-term incentives must be compatible with the long-term strategic goals of the firm.

Top executives have both short- and long-term performance incentives. Managers and executives have a wider area of discretion in making decisions that affect the firm. As a consequence, the PFP system is designed to reinforce a sense of commitment to the organization. Interestingly though, the tenure of CEOs at a particular firm has been decreasing from an average of 8 years to 4, so they may have a stronger short-term focus for the firm so that they can demonstrate their capabilities fast and be able to get another high-paying job. These short-term fast-payback projects or decisions might land them more money, but they might also prove to be bad deals for shareholders over the long term.[80]

In general, most managers receive bonuses related to profit. The amount is usually awarded as a percentage of their base pay, although there is a trend toward awarding lump sums not tied to the base pay. As higher profitability thresholds are attained, the manager receives bigger bonuses. The bonus structure for any given manager often depends on the relative contributions of all managers with the assessment of relative contribution made at a higher level. This method suffers from the drawbacks discussed previously regarding profit sharing for individuals. Many managers might feel that they have a negligible impact on organization profits. As the link between performance and pay becomes weaker, the reward loses incentive value. The link can be strengthened by clearly defining performance standards, while basing the amount of the reward on corporate profitability.

A stock option plan gives an executive the right to purchase a stock, over a specified period, at a fixed price. The theory is that if the executive is prudent and hard working, the stock price will go up. If the stock price does increase, the executive can purchase it at the lower fixed price, effectively receiving as a bonus the difference between the fixed purchase price and the higher market price.

Executives and their boards should be concerned with the long-term viability of the firm. Certainly after the turbulent recent economic times, many firms reversed their emphasis on stock plans so that now they only pay out when companies achieve long-term objectives. In fact, performance awards made up 41 percent of the long-term incentive value provided to CEOs in 2010, up from 37 percent in 2009, and stock options declined from 39 percent in 2009 to 34 percent in 2010. This was the best indication that firms were trying to align long-term incentives with longer-term company outcomes. Congress also periodically revises legislation controlling the awarding of stock options.[81]

Problems with options

Although take-home pay wasn't too shabby without them, CEO salaries went through the roof through abuse of stock options. Numerous experts endorsed the use of options on the assumption that executives would profit when shareholders profited. This is often not the case. As one expert concluded, "shareholders lost their shirts, but executives went right on raking in the dough."[82] Many companies awarded huge option grants despite terrible corporate performance by any reputable measure. Many companies simply adjusted performance goals for no particular reason. According to a stinging *BusinessWeek* exposé, almost 200 companies swapped or repriced stock options "to enrich members of a corporate elite who already were among the world's wealthiest people. When CEOs can clear $1 billion during their tenures, executive pay is clearly too high. Worse still, the system is not providing an incentive for outstanding performance." A recent study of executive stock options found that top executives often timed their option execution date on the most favorable stock price day of a given month, which increases the real cost of options not only to the employing firm, but also to the U.S. taxpayers. The study found that the executives were able to backdate their options and there were few internal controls (even post-Sarbanes Oxley).[83] Although there are many excellent websites, pay expert Graef Crystal's columns at www.bloomberg.com provide the most objective treatment of executive pay.

SARs

Restricted plans

Performance share plans

There are many variations of stock options. *Stock appreciation rights (SARs),* for example, do not involve buying stock. Having been awarded rights to a stock at a fixed price for a specified period, the executive can call the option and receive the difference between the fixed and market prices in cash. *Restricted stock plans* give shares as a bonus, but with restrictions.[84] The restrictions may be that the executive cannot leave the company or sell the stock for a specified time. *Performance share plans* award units based on both short- and long-term measures. These units are later translated into stock awards. Other incentive stock option plans are part of retirement packages. These may include profit-sharing and stock bonus plans. In both cases, employers pay into a retirement fund based on corporate profits. Recent evidence suggests that stock incentives may not be effective.[85]

"Clawback" provisions

Executive incentives of the future are more likely to be tied to long-term corporate performance, which may involve qualitative assessment of performance along with corporate financial performance. New products and service lines, environmental impact assessments, and new territorial penetration are some of the long-range measures that may be used to assess executive performance. For example, McDonald's, Burger King, and General Electric (GE) place considerable weight on their long-term growth in the European sector as a basis for compensating senior management. The trend in executive compensation is against heavy reliance on stock prices as a basis for compensating executives, since such reliance would promote short-term perspectives to the detriment of the long-term strategic plan of the organization. So-called clawback provisions in executive contracts are more likely where boards can demand cash returns by executives if information reveals performance decrements.

What about the Corporate Board Room?

Corporate boards have been called "America's last dirty little secret."[86] They have very lucrative and comprehensive compensation packages that are rarely linked to corporate performance. One study found that companies with outside directors who owned substantial stock holdings were less likely to overpay their CEO and, more importantly, presided over superior corporate performance.[87]

Little insight from corporate boards

One major flaw of corporate governance is that boards of directors in the United States provide little oversight and have been called "ornamental." As Warren Buffett has said, "in judging whether corporate America is serious about reforming itself, CEO pay remains the acid test."[88] So far, corporate America is failing the test.

"Boards pay CEOs after negotiations that are often more like pillow talk. Relationships are incestuous, and compensation consultants provide only a thin veneer of respectability by finding some 'peer group' of companies so moribund that anybody shines in comparison."[89] The result is the so-called **Lake Wobegon effect,** where all CEOs are judged to be above average. One study of 1,500 companies found that over two-thirds claimed to be outperforming their respective peer groups. Some boards have gotten more active in firing CEOs of poorly performing firms. Take the former CEO of Qwest Communications, Joseph Nacchio. He resigned under pressure when Qwest stock dropped 92 percent in 2 years.[90]

More shareholders' power may be the answer. Britain and Australia give shareholders more rights than in the United States. As stated earlier, relevant legislation such as the Shareholder Vote on Executive Compensation Act (**"Say on Pay Act"**) will be interesting to watch to see how much it affects executive pay levels. CEO pay in 2010 jumped 11% from the previous year. According to the *Wall Street Journal*/Hay Group 2010 CEO compensation study, company boards were starting to plan for those times when shareholders do not have such strong years, and shareholders were becoming more involved as evaluators of pay outcomes by using their own tools and philosophies, rather than simply following the views of the shareholder advisory groups.

HOW DO COMPANIES KEEP ENTREPRENEURS AND PROMOTE INTRAPRENEURS?

In the current climate of competitive pressures and great opportunity for launching new businesses, many companies are attempting to retain entrepreneurial mavericks within the corporate umbrella and promote intrapreneurial thinking. Many high-tech firms are funding employee ventures by using innovative compensation schemes. At IBM, employees can submit business plans for IBM risk capital. Employees can negotiate a share of the profits from an idea that they might have otherwise pursued on the outside.[91] The basic principle of entrepreneurial pay is that the employee places a major portion of salary at risk with the percentage of employee ownership of the venture determined by the portion of salary at risk.

Funding employee ventures

The potential for large returns replaces many of the standard perks expected by employees. Payoffs may have a variety of bases, from profits produced by the venture to increases in parent company stock value. Although such payoffs may be less than if the venture were truly independent, the risk for the employee is also more limited. In addition, there is the support and expertise available from the parent. American Telephone and Telegraph (AT&T), for example, wanted to increase the risk its people were willing to take in entrepreneurial efforts. Three venture approaches were offered, corresponding to the levels of risk the venture employee was willing to take.

Many companies have adopted special award programs for major entrepreneurial accomplishments. Microsoft, Merck, IBM, Amoco, Xerox, and AT&T, for example, have programs in which the awards can exceed $100,000 for research discoveries that lead to product development. These special programs are independent of any other PFP systems within the companies.

WHAT ARE THE MANAGERIAL IMPLICATIONS FOR PFP PROGRAMS?

Use a mix of PFP plans

A well-designed PFP system should lead to lower costs, higher profits, and a higher degree of individual or group motivation. Introduction of a well-designed PFP system can provide a more accurate estimate of labor costs as well as prompt workers to make more effective use of their time, supplies, and equipment. Using a mix of plans often has the best results. These same general principles also apply to small business. Research has clearly established

Figure 11-7
Three Strategic Positions for Pay Systems

1. **Pay the person.** People should be paid according to their individual market value—both internal and external. Pricing a job (not the individual) is not good enough. You need to measure knowledge, skills, and competencies of individuals against the external market.
2. **Pay-for-performance approach needs to translate business strategy into measures that can be used for reward system.** Individual, team-based, and business-based PFP systems all should have a place in any single organization for any single person.
3. **Individualize the reward system.** Individualize the system to fit characteristics of persons the organization wants to attract and retain. Avoid one-size-fits-all PFP systems.

Source: Ferris, Gerald R, Buckley, M. Ronald & Fedor, Donald B. (2002). *Human Resource Management: Perspectives, Context, Functions, and Outcomes,* 4th ed, Pearson Education. Reprinted with permission of the authors.

Sound measurement is key

that involving employees in the process of developing or changing a PFP system will ultimately lead to more effective results. Figure 11-7 presents three strategic positions to make PFP systems more effective. Once again, sound measurement is the key.

PFP systems are more complicated than lock-step, straight compensation. There are numerous challenges that must be met. Emphasizing one measure can lead to reduced performance levels in other measures. A strong focus on output or quantity can reduce quality, which could lead to increased costs in quality control. In addition, a focus on output could jeopardize safety.

Reward all important work dimensions

Remember the discussion in Chapter 7 about the definition of performance and the various aspects of value. A PFP system should reward all important dimensions of performance. An overemphasis on one dimension or one aspect of value such as quantity will result in a de-emphasis on other aspects such as quality.

A second challenge is the increased overhead expense of installing and maintaining the PFP system. Unless the production process is very stable, maintenance costs for PFP systems can be substantial, and consultants in this area are very expensive. A third challenge is the difficulty in setting standards that accurately reflect task requirements and are perceived as fair. This problem can be greater when a system adds new processes or equipment, as workers will be suspicious of new standards. A fourth challenge is that there will be resistance to any change involving employee compensation, particularly when base pay is affected. Unions have been born out of attempts to radically alter compensation systems. In addition to the typical fear of anything new, workers may oppose change to avoid being victimized by new rates and standards. The final challenge is that PFP systems are more likely to be subject to legal actions for possible discrimination.

More measurement ambiguity will result in more conflict

Management may resist change because of the expense of revising the pay system, the time required to do more valid performance measurement, and the difficulties that develop in defending PFP decisions. Finally, variations in pay due to performance differences may lead to conflict, a potential problem in a team or process-oriented work setting focused on the external customer. When measures are explicit and objective, some conflict will occur. When methods are subjective or ambiguous, as with the typical performance appraisal system, significant reward differences may not be perceived as justified, resulting in even greater conflict. Let's not forget the warning from the authors of *Freakonomics.* Incentive systems invite cheating and "gaming" of the system. Close monitoring is required. Over 200 companies were the subject of government investigations into whether they "backdated" their executives' stock options to maximize the value of the options, an illegal practice if the company does not take a charge for the value of the granted options. Executives and HR directors have gone to jail for this (apparently) common practice. We are also likely to see more examples of various forms of cheating related to the "high stakes" tests that students take that will have a direct impact on the pay and status of U.S. teachers.

Close monitoring is required

SUMMARY

PFP system must be compatible with long-term sucess

The PFP system must support the long-term competitive strategy and viability of the organization. If the strategy emphasizes entrepreneurial activity and independent effort, individualized PFP systems become increasingly important and effective. Incentive systems must also be compatible with organizational values. Closed, secretive cultures do not mix well with performance incentives. Openness and trust are necessary if employees are to accept the standards and believe in the equity of the rewards. Lincoln Electric's much touted piece-rate system would probably not be successful without the other elements of the Lincoln management system, which are based on mutual trust and a fair distribution of the products of hard work. Organizational culture clearly affects the nature of incentives selected and, in the end, the effectiveness of the system. Individual PFP plans are preferable when individuals contribute important criteria or attain certain outcomes that can be clearly measured and teamwork is not seriously undermined by the process of individual performance measurement and rewards. Highly interdependent jobs or groups will dictate group or organizational-based PFP plans.

Money is important

As one expert on the subject has put it, "Paying for performance will not solve all of the motivational problems associated with the new workforce and strong national competition. However, it can be an important part of a total performance management system that is designed to create a highly motivating work environment."[92] There is no question that money *is* a motivator. A key question is: Motivation for what? Following the measurement principles presented in Chapter 7 for defining performance is a critical step in linking the performance appraisal, performance management, and pay-for-performance systems. At Countrywide, mortgage lenders were paid when the mortgage contract was signed and "up-front" fees were paid, not if and when the mortgage was paid off.

There is probably no clearer example of incentive pay gone bad than the well-documented troubles in investment banking and insurance in 2008. Bankers got huge rewards when their high-risk investments did well. If those same strategies went sour down the line, they probably lost a bonus the next year. Many bankers even lost their jobs. But they almost never have to give back even a dime of the millions they made off their previous "bets" that ultimately put their company in jeopardy or out of business completely (think Lehman Brothers here). Pay for performance should include a provision about **"give-backs,"** or the release of money over time and subject to a longer-term assessment of the original investment or incentive scheme. There is a strong trend toward including "give-back" or "clawback" provisions as a part of executive compensation systems.

Pay consultant Alan Johnson may have captured the connection between compensation and the economic woes of 2008. "Wall Street is a sales business—they sell bonds, securities, transactions, ideas. . . . They're not paid to be long-term, philosophical, reflective. The pressure is to do the next merger, sell more stocks and bonds, do more trading—whatever boosts current profits and bonuses, the long-term consequences be damned."[93] Obviously, the long-term consequences should be the ultimate criterion in evaluating any incentive system, and the compatibility between this selling behavior and the long-term consequences are absolutely critical.

Long-term consequences should be the ultimate criterion

The bottom line remains that for any PFP system to work, rewards valued by the worker must be clearly linked to outcomes valued by internal and, most important, external customers and stockholders. Virtually all of the research on "high-performance work practices" supports the view that proper PFP systems can help to create and sustain a competitive advantage. The evidence supports the value of carefully designed PFP systems with a focus on long-term success measures. When the focus is on organizations that follow academic guidelines for development and maintenance, PFP systems look like a winner. A review of the vast literature provided a great "bottom-line" summary: "Every pay program has its advantages and disadvantages. Programs differ in their sorting and incentive effects, their incentive intensity and risk, their use of behaviors versus results, and their emphasis on individual versus group measures of performance. Because of the limitations of any single pay program, organizations often elect to use a portfolio of programs, which may provide a means of reducing the risks of particular pay strategies while garnering most of their benefits. For example, using only an individual incentive program could result in unacceptably high levels of competitive behavior and focus on overly narrow objectives. On the other hand, relying exclusively on gainsharing could result in the under rewarding of high individual performers, thus risking their attraction, motivation, and retention. However, **offering a mix of these different programs offers the possibility that the advantages of each can be captured, while minimizing the disadvantages.**"[94] In fact, most successful PFP plans (e.g., General Electric, Southwest Airlines, Whole Foods, Lincoln Electric, Nucor

Bottom-line on PFP systems: Offer a mix of programs

Offers a mix of tailored programs

Steel) use many different approaches including individual, group, and organization-level performance. All of these programs should be developed, administered, and evaluated in the context of the long-term success of the organization.

Chapter 12 discusses other HRM systems and characteristics that can also contribute to the productivity, competitive advantage, and long-term success of organizations.

Discussion Questions

1. Deming and others think PFP is a bad idea. What do you think?
2. Why is trust so important for PFP systems?
3. When is a group-based PFP system better than an individual system?
4. Some experts argue that a corporation's board of directors should be paid only with stock options. What do you think?
5. How would you go about combining individual and group-based PFP systems?
6. Some experts believe that if you have to use performance appraisals as the main source of data for a PFP system, you shouldn't bother with the PFP system. What do you think?
7. Under what conditions (if any) should a company install a forced-distribution rating system for PFP?
8. Conduct research on executive compensation contracts. Determine to what extent "clawback" or "give-back" provisions are part of the contract. Describe such a program and how the "clawback" works.

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