INTRODUCTION TO COMPENSATION

1

LEARNING OBJECTIVES

After reading this chapter, you should be able to understand —

- ⇨ Concept of compensation
- ⇨ Objectives and importance of compensation
- ⇨ Understand the components and dimensions of compensation
- ⇨ The dimensions of non-compensation system
- ⇨ Factor's effecting employee compensation

CONCEPT OF COMPENSATION

Compensation is a systematic approach to providing monetary value to employees in exchange for work performed. It is a tool used by management for a variety of purposes to further the existence of the company.

It may be adjusted according to the business needs, goals and available resources.

Definition

Compensation may be defined as money received in performance of work and many kinds of services and benefits that an organization provides to their employees.

Compensation is a systematic approach of providing monetary value to employees in exchange for work performed. It may help to achieve several purposes, such as recruitment, job performance and job satisfaction. It is also defined as the package of quantifiable rewards an employee receives for her or his labour. It represents both, the intrinsic (psychological mindsets resulting from job performance) and extrinsic (including both monetary and non-monetary) rewards. The term, compensation, refers to all forms of financial returns and tangible benefits that an employee receives as a part of employment relationship. In the globalization era, where the business environment has become increasingly complex and challenging, designing an effective compensation program to attract and retain talent is an important function of organizational effectiveness.

OBJECTIVES OF COMPENSATION

- To recruit and retain qualified employees.
- To increase or maintain morale/satisfaction.
- To motivate employees for better performance.
- To attract and retain skilled and talented workforce.
- To determine basic wages and salary administration.
- To achieve internal and external equity.
- To ensure equal pay for equal work, that is, each individual's pay is fair in comparison to that of another person doing a similar job.
- To support, communicate and reinforce an organization's culture, value and competitive strategy.
- To reduce turnover and encourage company loyalty.
- To reward for exceptional job performance with plans including bonuses, commissions, profit sharing, stocks, gain sharing etc.
- To control cost - A rational compensation system helps the organization to obtain and retain workers at a reasonable cost.
- Comply with legal regulation - A sound wage and salary system consider the legal challenges imposed by the government and ensures the employees compliance.

Morale and job satisfaction is affected by compensation. Often there is a balance (equity) that must be reached between the monetary value the employer is willing to pay and the sentiments of worth felt by the employee. In an attempt to save money, employers may opt to freeze salaries or salary levels at the expense of satisfaction and morale. Conversely, an employer willing to reduce employee turnover may seek to increase salaries and salary levels.

IMPORTANCE OF COMPENSATION PROGRAM

Compensation represents by far the most important element in the employment relationship and is of equal interest to the employer, employee and government.

To the employer; because it represents a significant part of his cost, is increasingly important to his employee's performance and to competitiveness and affects his ability to recruit and retain a labour force of quality.

To the employee because it is fundamental to his standard of living and is a measure of the value of his services or performance.

To the government; because it affects the aspects of macroeconomics, stability such as employment, inflation, purchasing power and socio-economic development in general.

Compensation will be perceived by employees as fair if based on systematic components. Various compensation systems have developed to determine the value of positions. These systems utilize many similar components including job description, salary ranges/structure and written procedures.

Job description: A critical component of both compensation and selection systems, job description define in writing the responsibilities, requirements, functions, duties, location, environment, conditions and other aspects of the job. Description may be developed for job individually or for entire families.

Job analysis: The procedure of analyzing jobs from which job description is developed. Job analysis techniques include the use of interviews, questionnaires and observations.

Job evaluation: A system for comparing jobs for the purpose of determining compensation levels for individual jobs or job elements.

Pay structure: It is useful for standardizing compensation practices. Most pay structures include several grades with each grade containing a minimum salary/wage and either step increments or grade range. Step increments are common with union positions where the pay for each job is predetermined through collective bargaining.

Salary surveys: Collections of salary and market data. It includes average salaries, inflation indicators, cost of living indicators and salary budget averages. Companies may purchase result of surveys conducted by salary vendors or may conduct their own salary surveys.

Policies and regulations: It includes fair policies of compensation, which is comprised of a system of components developed to maintain internal and external equity.

Total compensation package

Compensation or rewards (incentives) can be classified into:

(a) Direct compensation

(b) Indirect compensation

(c) Non-monetary compensation

Direct compensation includes money, popularly known as basic salary or wage, (gross pay) where the individual is entitled for his job, overtime work and holiday premiums, bonuses based on performance, profit sharing and opportunities to purchase stock option.

Indirect compensation includes benefits that may consist of life, accident, health insurance, the employers contribution to retirement (pension), pay for vacation or illness and employers are required to make payments for employees welfare as social security.

Non-monetary compensation can include any benefits an employee receives from an employer or job that does not involve tangible value. This includes career and social rewards such as job security, flexible hours and opportunity for growth, praise and recognition, task enjoyment, friendships etc.

CORE COMPONENTS OF COMPENSATION (ELEMENTS OF SUCCESSFUL COMPENSATION PACKAGE)

Compensation is one of the most important human resource functions in an organization. For many organizations, compensation is the biggest single cost of doing business. An organization's compensation system can help to reinforce the key corporate values and facilitate the achievement of organizational objective.

The total compensation package may be described in many ways, but is basically classified into various components.

Direct Compensation

(1) Base pay — It is the first component of executive remuneration. It is determined through job evaluation i.e., according to level of skill, effort and responsibility required to perform the jobs and the severity of the working conditions. Because paying a wage is a standard practice, the competitive advantage can only come by paying a higher amount.

(2) Bonus — It is mainly a gift given occasionally to reward exceptional performance or for special occasions. It plays an important role in today's competitive executive payment program. Bonuses can show an employer appreciating his/her employees and ensure that good performance or special events are rewarded. This type of incentive is usually short-term (annual) and is based on performance or profit sharing.

New English Dictionary defines Bonus as, A boon or gift over and above what is normally due as remuneration to the receiver and which is therefore, something wholly to be good.

There are basically four types of bonuses namely:

(1) Production bonus,

(2) Bonus as an implied term of contract between the parties,

(3) Customary bonus in connection with some festival, and

(4) Profit bonus.

Profit bonus has been given statutory recognition in the Payment of Bonus Act. Under this, the quantum of bonus depends on the extent of profit obtained in the relevant year. Executives deserve bonus because they have much more opportunity to influence organizational success than non-managerial staff.

(3) Long-term incentives or stock options — It is defined as a right to buy a piece of the business, which may be given to an employee to reward excellent service. If bonus constitutes short-term benefit, stock options are long-term benefits offered to executives.

An executive is given the right to purchase the company's share at afixed price. Stock option is valuable as long as the price of share keeps increasing. An employee, who owns a share of the business, or just a few acres, is far more likely to go an extra mile for the operation.

(4) Perks or perquisites — Perks constitute a major source of income for executives. In addition, to the normally allowed perks like provident fund, gratuity executives enjoy perks such as vacation travel, membership in club and well-furnished houses. In many cases, companies take care of servants, telephone bills and even car fuel.

While monetary incentives often appear as important motivators, many factors unrelated to money can also serve as, " attention-getters" and " encouragers of action". The classification of such non-financial incentives tends to a source of desirable 'things' that are potentially at disposal of the organization.

The creation of such rewards is only limited by manager's ingenuity and ability to assess payroll's that individuals within the organization find desirable and which are within the manager's jurisdiction".

Indirect Compensation

In a tight labour market, indirect compensation becomes increasingly important. Businesses that cannot compete with high cash wages can offer very individualized alternatives that meet the needs of the employee. Some of the indirect compensation alternatives are:

- Flexible working schedules.
- Elder care
- Retirement programs
- Moving expenses
- Insurance (health, eye, dental)
- Subsidized housing
- Paid leaves (sick/holiday/personal days)
- Subsidized utilities
- Tickets to events (ball games, concerts)
- Magazines subscriptions
- Boots and clothing
- Laundry services
- Company parties
- Use of machinery, farm produce goods/meals
- Cellular phones/pagers
- Child care.

Non-monetary benefits: These includes challenging job responsibilities, competent supervision, offer supportive leadership and management, comfortable working conditions etc.

DIMENSIONS OF NON-COMPENSATION SYSTEM

Non-compensation rewards: These rewards have an indefinite number of components that relate to the work situation and to the physical and psychological well-being of each worker. (Richard Henderson).

The model of non-compensation system is mentioned in the figure below:

Dimension of Non-compensation System

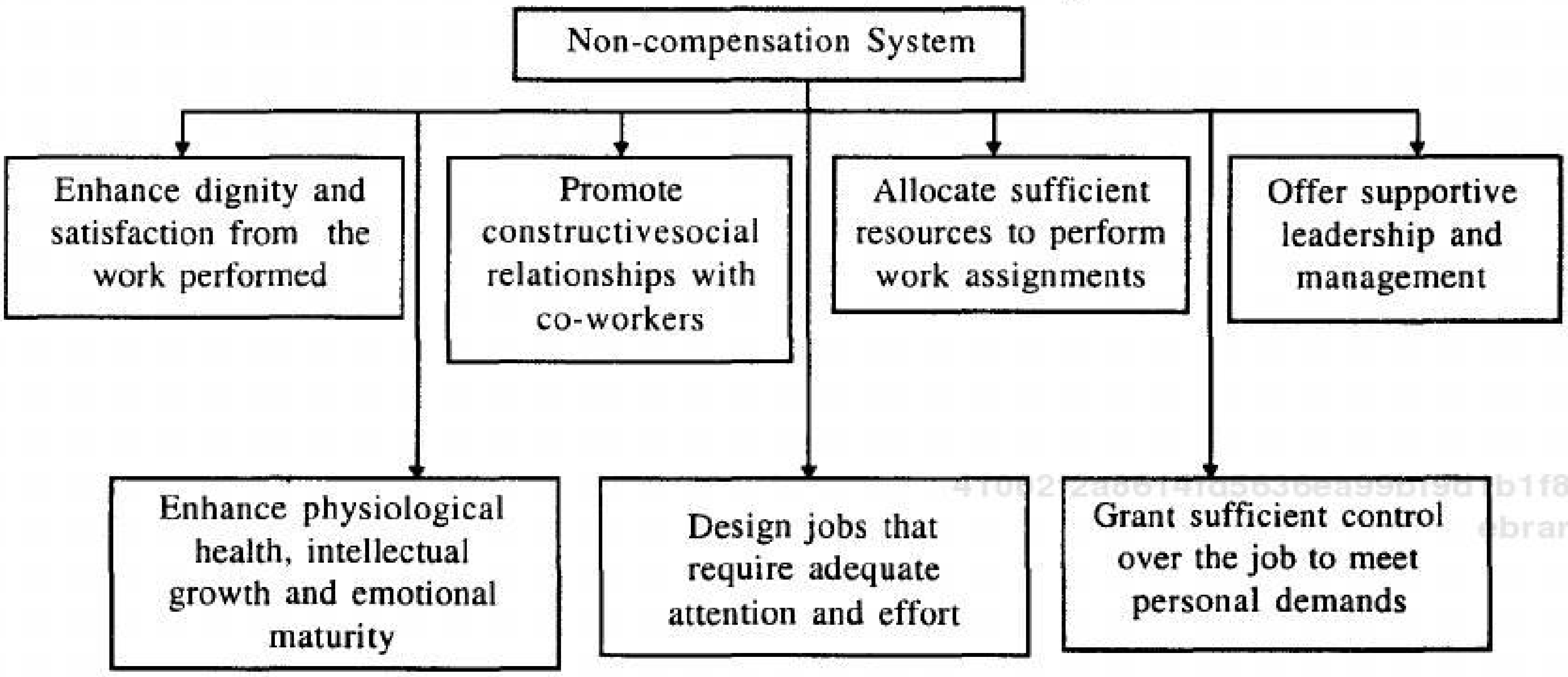

Fig. 1.1

Source: Henderson Richard 1, "Compensation Management in Knowledge Based World", p.-23."

(1) Enhance dignity and satisfaction from work performed

It is the most powerful and motivating reward by an organization to an employee to recognize the person as valuable asset of that particular organization. It is less costly and enhances the feeling of pride and satisfaction among the members. Every compensation and non-compensation reward component should carry with it the message, "we need you and appreciate your efforts."

(2) Promote constructive social relationships with co-workers

It is a valued reward for an employee to get an opportunity to interact and communicate with other people. A work place environment where trust, fellowship, loyalty and love emanate from the top level of management to the lowest level of the organization promotes the kinds of social interaction most people need in order to thrive. Any feeling of jealously, conflict and discontent destroys constructive relationship and decreases the level of productivity. Therefore, it is necessary for an organization to improve social relationships among employees and encourages team-based approach.

(3) Allocate sufficient resources to perform work assignments

It is essential to allocate sufficient resources to an employee for the accomplishment of the goal. If employees do not have knowledge or skills for certain assignments than this is a failure or dissatisfaction for not only the organization but also for employers. It decreases morale and motivation level of an individual. An organization must do everything possible to assist the employee in completing missions successfully. It is necessary for an organization to offer sufficient time to accomplish an assignment along with necessary human, technical, or physical resources and some degree of challenge and assurance.

(4) Offer supportive leadership and management

This dimension is recognized as unique dimension of the non-compensation reward. All individuals require guidance and support of those who help them in achieving their goals. They look to managers who have influence and can bring about desired changes. Employees faith and trust in management assist in establishing workplace environment where job security becomes accepted, social interaction thrives, and where work satisfaction is possible. Supportive leadership includes skill and interest in coaching and counselling, appreciation, recognition, constructive feedback leading to improvement of job performance.

(5) Enhance physiological health, intellectual growth, and emotional maturity

There is always a necessity of safe working environment, as any health related problem effects intellectual growth and emotional maturity of an employee. Provision of safe equipment i.e., a work environment that is risk free, minimization of noxious fumes, avoidance of extreme heat, cold and humidity conditions, elimination of carcinogens and other disease related material and substances is expectation of all employees. Additional stress is caused by technological advancement that requires rapid changes in the knowledge and skills of workers. Although these problems are universal and almost impossible to overcome, management can recognize their existence and can take action to limit their negative influence on the performance of each employee.

(6) Design jobs that require adequate attention and effort

When an activity is no longer challenging, innovative and the employee feels boredom and discontented, special attention has been focused on scientific management efforts to specialize work assignments where workers were required to perform these few tasks for as long as they remained on the job. This leads to employee frustration, absenteeism, job turnover and declining performance. To overcome this problem, behavioural scientists and managers at all levels have been searching for and implementing new approaches to improve the quality of work life. Restructuring of job tasks, job redesigning and job responsibilities are receiving top attention. Diversification and flexibility in job requirement is being provided by rotating jobs and by giving employees more opportunities to schedule work days and work weeks.

(7) Grant sufficient control over the job to meet personal demands

The decision of granting greater opportunity for the employees to participate in decision making process of the organization is gaining more importance. One of the most important decisions being made by more and more workers is that of scheduling work activities, and in some cases, of choosing the location of assignments. With the advent of the personal computer and networking, more employees are allowed to work at home or at a worksite of their choice.

Like many other non-compensation rewards, the benefits gained by granting such privileges frequently outweigh the costs of having an additional employee on the payroll. Also an option of casual dress wear makes life easier.

Some examples of non-monetary incentives

The need-motives for affiliation, power and recognition in particular, can be appealed by such incentives.

- A person with strong need for affiliation may respond readily to job assignments, that provide with opportunities to relate to socially attractive and satisfying individuals or groups.
- The opportunity to communicate with and relate to others is a factor many workers emphasize and seek.

- Persons who are very status conscious, can be motivated with the ability of a panelled office or various kinds of status symbols.
- An employee with high level desires for power may respond easily to opportunity, whereby he can gain leadership and administration responsibilities.
- The use of job enlargement provide added incentives to some employees because they feel capable of controlling wider sets of activities than they previously performed.
- Workers in safety minded organization are often attracted by competition on awards for best safety performance records.
- Individuals proud of their past accomplishments may feel recognized and rewarded if their superiors extend opportunities for participation on more complex and more important job assignments.

FACTORS EFFECTING EMPLOYEE'S COMPENSATION

There are number of factors influencing the compensation package payable to employees. They can be categorized into

(1) External factor

(2) Internal factor.

External factors

These are demand and supply of labour, cost of living, society, labour unions, legislation, economy and compensation survey.

(1) Demand and supply of labour: Even in times of high employment, individuals with certain skills or abilities are in demand. This demand and supply of labour influences wage and salary fixation. Jobs in high demand frequently will receive premium wages, as in case of skilled labour. However, if supply of labour exceeds the demand, then employers are willing to pay less. High remuneration to skilled labour is necessary to attract and retain it. But exploitation of unskilled labour, like, for instance, paying less wages because it is available in plenty, is unjustifiable. The Minimum Wages Act, 1948, is precisely meant to prevent this kind of exploitation.

The basic point of this approach is that firm pays its employees the "going rate" for the type of work they do. Going rate analysis is done by reviewing all job description and then collecting relevant salary market data through participating in national, regional, and local salary surveys and by third party survey administrators (generally human resources consulting firms).

Going rates are those that are paid by different units of an industry in a locality and by comparable units of the same industry located elsewhere. If the firm offers pay much below the going rate, it may be unable to attract and retain qualified workers. If it pays much more than the going rate, it may be unable to charge comparative prices for its product because its labour costs are too high.

Productivity of labour also influences wage fixation in labour market. Productivity can arise due to increased effort of the worker, or as a result of the factors beyond the control of the worker such as improved technology, better management etc. Greater effort of the worker is rewarded through piece – rate or other forms of incentive payments.

Productivity is the relationship between the input of labour measured in man-hours and its output in the form of money or physical terms. Productivity linked wages may help utilize human resources better and help determine fair wages.

(2) Cost of living: The logic for using cost of living as a pay determinant is both simple and important. A pay increase must be roughly equivalent to the increased cost of living, if a person is to maintain a precious level of real wages. A rise in the cost of living is sought to be compensated by payment of dearness allowance, basic pay to remain undisturbed. Some firms even index pay increases to the inflation rate and sacrifice merit pay to provide across the board increases designed to offset the results of inflation.

(3) Society: Compensation paid to employees often affects pricing of the firms goods or services. For this reason, consumers may also become interested in compensation decisions. Businesses in a local labour market are also concerned with the pay practices of new firms locating in their area. The Supreme Court has been keeping social and ethical considerations in adjusting wage and salary disputes. It was also considered to keep the company wages in line with other wages in the community.

(4) Labour unions: The presence or absence of labour organizations often determine the quantum of wages paid to employees. When union uses comparable pay as a standard in making compensation demands, the employer needs accurate labour market data. When a union emphasizes cost of living, it may pressure management into including a cost of living allowance. The employees of strongly unionized companies too, have no freedom in wage and salary fixation. They are forced to yield to the pressure of labour representation in determining and revising pay scales.

(5) Legislation: There are numerous Legislation Acts which affect the compensation system. Equal employment legislation, including The Civil Rights Act, Family and Medical Leave Act, Payment of Wages Act, 1948; The Payment of Bonus Act, 1965; Equal Remuneration Act, 1976; Payment of Gratuity Act, 1972 etc. The Payment of Wages Act seeks to protect workers against irregularities in payment of wages and unauthorized deductions by the employer. The Minimum Wages Act enables the Central and State Governments to fix minimum rates of wages payable to employees in sweated industries. The Equal Remuneration Act provides for payment of equal remuneration to men and women workers for same or similar work. The Equal Pay Act, 1963 prohibits an employer from paying an employee of one gender less money than an employee of the opposite gender, if both employees are performing same nature of job. (same skill, effort and responsibility).

In addition to legal enactment's, there are wage boards, tribunals and fair wages committees which aim at providing a minimal standard of living to workers. Also there is the Companies Act, 1956, which checks the managerial remuneration.

(6) The economy: The economy definitely affects financial compensation decisions. For example, a depressed economy generally increases the labour supply and lowers the market rate. On the other hand, a booming economy results in greater competition for workers and price of labour is driven upward.

Since the cost of living is commonly used as pay standard, the economy's health exerts a major impact upon pay decisions. Cost of living typically rises as the economy expands.

(7) Compensation survey: A compensation survey strives to obtain data regarding what other firms are paying for specific jobs within a given labour market. The surveys may be either outsource to a consulting firm or conducted by the organization itself. In this, market rates remain the most important standard for determining pay.

Most big organizations provides low, high and average salary for a given position with the help of compensation survey. It provides information for establishing both direct and indirect compensation. A firm should take the determinants such as the geographical area of the survey and the specific firms to contact before conducting a compensation survey.

Internal Factors

Among the internal factors that affect pay structure are the compensation policies, organizational ability to pay, job analysis, and job descriptions, employee, trade union's bargaining power.

(1) Compensation policies: It provides general guidelines for making compensation decisions. The first thing employers should consider when developing compensation package is fairness. It should be vital and maintain internal and external equity. The policy should include the company's philosophy related to the major components of incentive compensation, including the strengths and weaknesses of each and how the overall plan provides optional alignment of interest with shareowners.

The policy should provide broad guidelines by which the company will use alternative forms of compensation, and the relative weight in relation to overall compensation if "others" form of compensation will be utilized. An organization often, formally or informally, establishes compensation policies that determine whether it will be a pay leader, a pay follower, or strive for an average position in the labour market.

(*Source:* R. Wayne Mondy and Robern M. Noe)

(i) **Pay leaders:** They are organizations that pay higher wages and salaries than competing firms. This helps to retain and attract high quality and productive employees.

(ii) **The market rate:** These are the average pay that most employers provide for a similar job in a particular area or industry, it is also known as going rate.

(iii) **Pay followers:** These are companies that choose to pay below the market rate because of poor financial condition or a belief that they simply do not require highly capable employees.

(2) The organizational ability to pay: An organization's ability to pay is also an important factor in determining compensation package. Companies that have good sales and, therefore, high profits tend to pay higher wages than those which running at a loss or earning low profits because of the high cost of production or low sales. However all employers, irrespective of their profits or losses, must pay no less than their competitors to attract and retain potential employees.

(3) Job analysis and job description: It is found that the more difficult and challenging a job, the higher are the wages. For this, the particular job is analyzed and then the relative value of a job is determined. Job analysis is the systematic process of determining the skills and knowledge required for performing job.

(i) Determine what tasks must be accomplished by whom.

(ii) Decide which job classifications should be exempt and which should be non-exempt.

(iii) Develop model job descriptions for exempt and non-exempt positions and distribute the models to incumbents for reviews and comment; adjust job descriptions if necessary.

(iv) Finalize and document all job descriptions.

(v) Evaluate jobs.

(vi) Also a general task analysis is conducted by major departments to the jobs within each senior.s, vice president's and manager's department and then rank jobs between and among departments.

(vii) Verify ranking by comparing it to industry market data concerning the ranking and adjust if necessary.

(viii) Prepare a matrix organizational review.

(ix) Determine grades.

(x) Establish the number of levels – senior, junior, intermediate and beginner for each job family and assign a grade to each level.

(xi) Determine the number of pay grades, or monetary range of position at particular level and establish the salary range.

(4) Employee: In addition to all the above factors, employee related factors are also important in determining wage structure. These factors include performing on the job, seniority experience, and membership in the organization and their potential.

Trade union's bargaining power

The stronger and more powerful the trade union in any organization, the higher the wages. Trade union's bargaining powers are often measured in terms of its membership, its financial strength and the nature of its leadership.

KEY TERMS	
Compensation	Cost of living
Base pay	Pay followers
Perquisite	Going rate
Non-monetary incentives	

SUMMARY

This chapter identifies and briefly describes the concept of compensation, its objectives and importance. The various objectives of compensation are to recruit and retain qualified employees, to increase morale of employees, reduce absenteeism, job turnover and mainly to determine basic wages and salary administration.

Total compensation package or rewards (incentives) can be classified into:

(a) Direct compensation

(b) Indirect compensation

(c) Non-monetary compensation.

Direct compensation includes money, popularly known as basic salary or wage, (gross pay) where the individual is entitled for his job, overtime work and holiday premiums, bonuses based on performance, profit sharing and opportunities to purchase stock option. Indirect compensation includes benefits that may consist of life, accident, health insurance, the employers, contribution to retirement (pension), pay for vacation or illness and employers are required to make payments for employees welfare as social security.

Non-monetary compensation can include any benefits an employee receives from an employer or job that does not involve tangible value. There are number of factors influencing the compensation package payable to employees. They can be categorized into:

(1) External factor

(2) Internal factors

External factors: These are demand and supply of labour, cost of living, society, labour unions, legislation, economy and compensation survey. Among the internal factors that affect pay structure are the compensation policies, organizational ability to pay, job analysis, and job descriptions, employee, trade union's bargaining power.

To operate within a competitive environment, organizations must understand how to correlate and influence their compensation practices and make the kinds of reasoned decisions that permit them to function effectively and efficiently.

REVIEW QUESTIONS

1. Define the term compensation.
2. Identify the major parts of the compensation program.
3. Distinguish between monetary and non-monetary compensation .
4. Bring out the components of employee remuneration.
5. Outline the various factors that effect compensation.
6. What differences can an employer's philosophy have on rates of pay?

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STRATEGIC PERSPECTIVES IN COMPENSATION

2

LEARNING OBJECTIVES

After reading this chapter, you should be able to understand —

- Aligning compensation strategy with business strategy
- Strategic pay decisions
- Trends in compensation
- Competency based compensation programme
- Diagnosis and benchmarking
- Influence of pay on employee attitude and behaviour

ALIGNING COMPENSATION STRATEGY WITH BUSINESS STRATEGY

In recent years, the necessity for organizations to control labour costs, while at the same time increasing productivity and enhancing quality and customer service, has never been more urgent. Although, many companies have become acutely aware of this problem, few companies have yet to fully address this issue. The present competitive environment requires new strategies toward employee compensation, new management and employee practices, and new methods of educating employees to the shifting competitive environment that has brought about the necessity for these changes.

At the same time that companies are examining the method and basis for compensating employees, there has been a growth in the number of companies seeking to develop high performance and high commitment work systems. These systems, based upon expanded roles for employees, requires the employees to accept more responsibility and accountability.

Other organizational initiatives, such as flatter organization structure; more fluid organization design; and faster-paced, quicker-response customer focus have driven sweeping changes. Often it has been difficult for compensation systems to keep pace and support these changes. Additionally, employee compensation is a critical component to financial success. Careful attention must be placed on the development of reward systems that reflect the financial capability of the company, as well as reinforce the new directions associated with contemporary organizational strategies. Compounding all of these problems are the recent dynamics of the labour market. In contrast to the period 1985-1995, when wages and salaries grew only modestly, the period 1996-1997 has been marked by an increasingly dynamic labour market in which wages and salaries are beginning to grow at a pace not seen in many years. The tightened labour market has meant that, for the first time in many years, greater attention must be given to the traditional role of compensation, i.e., attraction and retention.

Changing compensation systems is a difficult task for any organization. Employee and management perceptions of organizational compensation systems are typically well-formed. Concerns and skepticism over how they will be affected by any new system are natural. It is difficult for organizations to achieve compensation driven changes in behaviour if their compensation plans have not been adequately communicated, employee understanding and trust established, and new expectations firmly "seated" and accepted. It goes without saying that communications, training and execution are critical.

Compensation in the high performance organization needs to reinforce the directions set by the leadership. We under score the word reinforce as efforts to make compensation too great a driver for change, may lead to unintended consequences. That is, if the organization becomes too heavily compensation driven, the focus may be lost on the factors leading to successful high performance organization and instead toward short-term compensation goals.

Compensation philosophy is the set of values and beliefs that an organization has in regards to compensation decision-making. This often is combined with a set of guiding principles that further assist in compensation administration. Many firms report that they have no formal compensation philosophy and this would certainly be true of many we have worked with over the years. However, we would argue very strongly that the collection of decisions that the firm has made over a period of time constitutes a compensation set of beliefs and values — a compensation philosophy —regardless of whether or not the firm has actually committed those ideas to a formal document.

Compensation strategy issued to guide the design of specific compensation decisions.

Differences in compensation philosophies are widespread. Thus, some organizations believe in the widespread use of incentive compensation, while others only apply incentive compensation to a very narrow group of employees who are believed to affect the bottom-line. This represents a significant philosophical difference between the firms. Another illustration may be found in the examination of the behaviour of firms who seek to apply compensation levels "at the mid-point." These firms differ philosophically from those firms that seek to pay at the top of the market, thus enabling them to attract the highest calibre employees that they can find. Business settings often explain these differences. Somefirms are proportionally more generous to certain levels to exempt employees, while others believe in principles of achieving widespread equity across all employees. The openness with which compensation decisions are made, and the degree of stakeholder involvement in those decisions, is yet another example of philosophical differences that may exist between organizations.

Needless to say, compensation is a key issue for the high performance organization, as the employee and management systems utilized by the organization must be reinforced through the rewards structure. Again, our experience is telling in avoiding making compensation unduly controversial, thus adversely affecting the very heart of the high performance system.

It is important to approach compensation strategically by developing a philosophy toward compensation, along with a set of objectives. Three factors are employed:

(1) business and operating inputs;

(2) industry and labour market practices and trends; and

(3) employee inputs and preferences.

Once a philosophy and objectives are developed, the four elements of compensation can be determined. Base pay structures deliver to employees their wage or salary. Employees typically receive 90-100% of the cash compensation and two-thirds of their total compensation from their base pay.

Variable pay plans are organizational systems for sharing the economic benefits of improved productivity, cost reductions, quality, and overall business performance in the form of regular cash bonuses. Most variable pay plans incorporate existing, or develop enhanced systems of employee involvement. To develop a variable pay plan system requires examination of existing management and compensation practices. In most cases, fringe benefit structures are set at a corporate level and are highly influenced by legal requirements.

From the point of view of compensation strategy, fringes represent a substantial cost of total compensation and therefore must be considered as a strategic cost. Organizations derive little if any behavioural change from this portion of compensation. Fringes can influence attraction and retention.

Compensation administration includes a collection of activities required to sustain the effectiveness of a compensation strategy. Thus, issues ranging from labour market surveying to performance management to skill certification and peer review come under this umbrella. Involving stakeholders in compensation administration can reinforce the values and beliefs underlying the compensation philosophy and strategy.

Thus compensation decisions should be fully integrated into the organization's business and operations strategy, through its compensation philosophy. The design of compensation systems should be subsequent to, and not precede, this key analysis and decision point. For the high performance firm, an appropriate level of employee involvement can further reinforce the organization's general beliefs and values.

Below we provide a checklist of key compensation questions.

➢ Base Pay Delivery

- Method of delivery — Job-based *vs.* individual-based
- Number of levels
- Structure of levels
- Pricing strategies
- Adjustment method
- Weighting of individual performance.

➢ Organization Performance or Variable Pay

- Role in total compensation strategy
- Structure
- Measures

- Targets
- Tolerance for pay at risk
- Risk - reward ratios
- Use of other monetary rewards
- Use of non-monetary rewards
- Individual performance recognition.

➢ Fringe Benefits

- Usually determined at corporate level; limited scope at other levels
- Tie to business and human resource objectives
- Coverage
- Cost
- Communications (purpose-coverage-value)

➢ Compensation Administration

- Stakeholder role in compensation administration
- Performance management and evaluation
- Overtime policy (exempt and non-exempt)
- Shift differentials
- Attendance policy
- Role of seniority.

➢ Employee Inputs and Preferences

- Perceptions of external pay equity
- Perceptions of internal pay equity
- Pay delivery beliefs
- Form (cash, gainsharing, benefits)
- Method (individual, small group, large group)
- Risk tolerance
- Trust in management

➢ Business and Operating Inputs

- Operations and manufacturing strategy
- Sales development strategy

- Percentage of compensation costs to total product/service costs
- Percentage of compensation costs to controllable product/service cost
- Existing markets/products
- Potential markets/products
- Anticipated volume
- Reinforce/enhance work design
- Maintain cultural change processes
- Other operating issues.

➢ Industry and Labour Market Practices and Trends

- Availability and quality of work force
- Industry practices
- Retention of work force
- Retention of key contributors
- Wage/salary levels and movement
- Wage/salary delivery charges

➢ Compensation Philosophy and Objectives

- How much emphasis should be placed on rewards to drive organization
- What issues are to be driven by compensation as opposed to management practices
- Market definition (exempt and non-exempt)
- Method of delivery
- Targeted position in labour market
- Targeted position in product market
- Relationship within total company
- Relationship to selection and retention
- Portion of pay guaranteed and at risk
- Percentage of workforce bonus eligible.

STRATEGIC PAY

"Pay structure has strategic value that assigns different pay rates for jobs of different values which differentiate individual employee contributions. A well designed pay structure is one which attract and retain potential employees.

A company's pay structure is the method of administering its pay philosophy. The two leading types of pay structures are the internal equity method, which uses a tightly constructed grid to ensure that each job is compensated according to the jobs above and below it in a hierarchy, and market pricing, where each job in an organization is tied to the prevailing market rate.

A company needs job descriptions for all its positions so that people know where they fall within the organization. A pay structure helps answer questions about who's who, what each person's role is, and why people are compensated differently. It also helps human resources personnel to fairly administer any given pay philosophy. For example, a company might want to pay everyone at market; or pay some people at market and some above it. Opportunities for incentives are also dealt with in the pay structure. For example, people with strategic roles will likely have opportunities for higher incentives.

Out Source if Necessary

Many firms have one or more in-house compensation consultants who can set up a pay structure consistent with the company's pay philosophy. Small organizations and other companies without the resources to hire a compensation consultant can either train someone in how to set up a pay philosophy, or outsource this service.

How to construct a pay structure

Compensation specialist develop pay structure based on five steps:

(i) Deciding on how many pay structure to construct

(ii) Determining a market pay line

(iii) Defining pay grades

(iv) Calculating pay ranges for each pay grade

(v) Evaluating the results.

Effective administration of pay structure requires a balance between the pay levels for employees inside the company (internal equity) and the pay level those employees could command in the company's recruiting markets (external equity).

Business considerations for pay structure design include strategic issues, competitive practices, the organizational culture, and the affordability of pay. The key strategic issues to consider are the objectives of the company and the extent to which salary will be used to attract and retain employees capable of achieving business success. Also the salary practice of competition in consideration, surveys that report data regarding how they structure their salary administration program organization with a dynamic culture tend to place less emphases on basic pay in favor of variable pay, which has greater impact on employee's behaviour for achieving business objectives.

Whereas organization with states cultures, place emphases on base pay because they can reasonably predict business performance and employee behaviours.

Technical considerations for pay structure design include the number of range levels, width of the ranges from minimum to maximum values (i.e., range spreads), the distance between adjacent range midpoint values (i.e., midpoint differentials), and the degree of overlap between adjacent ranges. The number of ranges in a salary structure is a characteristic that describes the number of hierarchical levels needed to distinguish the value of jobs in the organization. The number of ranges required to compose a complete structure is determined by the following considerations:

- The number of skill and/or responsibility distinctions evident in the organization's job worth hierarchy.
- The number of supervisor-subordinate relationships in the company's organizational structure.
- The degree of emphasis on career development and progression.
- The resources available to administer the pay program.

Generally, the more range levels, the more administration required.

The "range spread" is a characteristic of salary structures that describes the distance between the minimum and the maximum salary range values. The degree of range spread is dependent on a balance between the internal value a company places on the job and the range of salaries paid to comparable jobs in the relevant recruiting markets. Essentially, spread reflects the range of salary opportunity for the jobs that are assigned to the range, from a minimum to maximum salary values.

To calculate range spread, divide the difference between the maximum and minimum values by the minimum value. In general, wider ranges apply to jobs that are determined to have larger salary values (e.g., executive jobs), whereas narrower ranges apply to jobs with smaller salary values (e.g., clerical jobs). Midpoint differential is a characteristic of salary structure design that describes the percentage difference between the midpoint values of adjacent salary ranges. In general, if the company's job evaluation approach doesn't discriminate finely between levels, the result will be fewer salary range levels. Another factor to consider in concluding midpoint differentials is the company's policy with regard to the cost of promoting employees into jobs at higher salary range levels. For example, a policy that limits promotional salary increases to 8%, but with a midpoint differential of 15%, may result in salaries for the promoted employees to fall below the new grade minimum salary value. The degree to which ranges overlap each other's salary values is a function of midpoint differentials and range spreads. Analyze range overlap after decisions have been made about midpoint differentials and range spreads to ensure that there is a reasonable progression between the range levels that compose the salary structure; and adjust if necessary.

Traditional Structures

Many salary ranges that have narrow range spreads, small midpoint differentials, and broad overlap between adjacent ranges characterize traditional structures. Traditional structures tend to place greater emphasis on internal equity, as opposed to external equity. Traditional structures focus on job content evaluation to arrange a job worth hierarchy.

With a focus of internal factors to create traditional structures, evaluation of market salary levels is limited to having a secondary influence on the arrangement of the job worth hierarchy. As a consequence, the company is likely to make many more distinctions between company jobs than may actually exist in relevant recruiting markets.

Traditional structures are best suited to companies that recognize and reward employee performance with promotions to jobs assigned to higher salary ranges, as opposed to moving an employee's salary deeper within the range over time.

Broadbanding

Broadbanding is a method of grouping jobs and determining pay that makes compensation administration more flexible and more responsive to the needs of changing organizations. Broadbanding eliminates the present hierarchical grading structure and narrow salary ranges. In broadbanding, jobs with similar responsibilities and skill requirements are grouped in "bands" of job families, and pay is linked to the market. The approach reinforces and values the employees' role within the University and the development of competencies to perform the role successfully.

Broadband Structures

By definition, broadbanding is a salary structure that consolidates the relatively large number of ranges found in a traditional structure into fewer ranges. Because there are fewer ranges, a Broadband salary structure has characteristics that distinguish it from a traditional structure. Fewer salary ranges that have wider range spreads, larger midpoint differentials, and a lesser degree of overlap characterize broadband structures. Broadband structures tend to place greater emphasis on career development opportunities that employees would otherwise seek in the company's recruiting markets.

Broadbanding has been a recognized practice of corporate compensation professionals.Organizations that implemented broadband structures sought to improve the administration of the salary program subsequent to downsizing initiatives that created flatter organizations. In flat hierarchies, greater emphasis tends to be placed on career development as opposed to job promotion. Today, broadbanding still refers to collapsing a company's job worth hierarchy into fewer, wider salary ranges. This is done to manage pay delivery in a manner that recognizes career growth in light of fewer promotional opportunities, and company pay practices that are closely tied to competitive levels.

Broadbanding usually appeals to organizations that want to be more nimble in response to persistent changes in business conditions or recruiting markets. Such organizations would likely implement broadband salary structures in attempt to achieve the following human capital management objectives:

- Broader workforce skills
- Career development among employees
- Improvement in the way of job evaluation, salary structures, and performance rewards are administered and maintained.

Broadbanding is a compensation management's response to changing business conditions. In broadband salary structures, employers reward employees who demonstrate substantial capability improvements with a salary progression that penetrates more deeply into the banded range over time, in lieu of promotions. Whereas the design characteristics of traditional structures emphasize internal equity and focus the employee's attention on the world inside the firm, broadbanding focuses employees on the changing needs of the organization and helps them experience an internal culture that more closely reflects the external business environment and the competitive recruiting market.

Occasionally, employee salaries may fall outside the company's defined salary range for the job. The employee salary will either be above the maximum value or below the minimum value. Salaries that fall above the maximum are referred to as red-circle rates.Red-circle rates may be caused by demotion, an exceptional salary paid to retain a high-potential employee, reorganization or acquisition, or the structure falling behind competitive circumstances. Actions compensation professionals suggest for resolving red-circle rates include freezing the employee's pay until the salary falls back inside the updated range, reducing the employee'spay and paying the excess in the form of a bonus, or reviewing the employee for promotion into a higher salary range.

In contrast to red-circle rates, green-circle rates are where the employee's salary falls below the range minimum. Green-circle rates may be caused by adjustments to the salary structure subsequent to a recent promotion or new hire, reevaluation of the job's value causing reassignment to a lower range in the structure, or reorganization or acquisition.

Compensation professionals recommend that employees not be paid salaries below the company's prescribed minimum value. The employee's salary should be raised to the range of minimum value immediately, or at some scheduled event in the salary administration process, such as annual salary review.

Pay compression can occur when the pay rates of several employees, despite clear differences in capability, are in a cluster. This means highly capable employees are paid similarly to employees with less skill and experience. This eventually creates morale problems, particularly for the more capable employees.

Modern organizations are making very significant changes in their compensation systems in order to better fit the dynamic, highly competitive business environment. Firms increasingly are using things such as skill-based pay, which compensates employees for the number and types of skills they possess instead of the type of job they have. Similarly, there is a strong movement to "at-risk" compensation, where employee pay is tied to performance. Under this system, the employee's bonus does not become part of his or her base pay. Instead, the bonus must be re-earned each year. These changes, and numerous others, are designed to help offset compensation costs by gains in productivity, and to develop more flexible workforces.

The respondents with skill based pay programs indicated that the primary reasons for developing a skill based pay program are as follows:

- encourage skill development
- reward learning
- create fewer titles
- encourage more flexible work assignments.

Table 2.1

Definition	A pay structure is a collection of pay rates or pay ranges. Structure setting and adjustment is the process of developing, adjusting, and maintaining a pay structure.
Purpose	Pay structures are used to help organizations:
	• maintain pay levels that are competitive with the external labor market, • maintain internal pay relationships among jobs, • recognize and reward differences in the level of responsibility, skill, and performance, and • manage pay expenditures. • Structure setting and adjustment provides a systematic way to manage pay
Elements of a pay structure	A pay structure is defined by several elements, including: • coverage – the occupations, positions, or persons included, • the number of pay ranges or grades, • the differences between pay ranges, and • range width – the difference(s) between the range minimum and maximum structures.

Table 2.2

Types of pay structure	**Common approaches to establishing pay structures include:**	
	Approach	**Common characteristics:**
	Traditional (Grades)	• separate structures for each employee type (e.g., non-exempt, salaried non-exempt, exempt, executive), function, or occupation, • many ranges or grades (often 10 or more), • narrow ranges (15% – 50% for professional positions), and • small to moderate differences between grades
	Broadbanding ("Broad grades")	• separate structures by employee type, relatively few ranges (4 to 6 bands are common), and • wide ranges (50% to 80% for white-collar non-managerial positions) • Federal broadbanding: • maintains distinctions between developmental and full performance level positions, • may include technical and administrative support occupations, and • typically has more grades and narrower ranges than "pure" broadbanding.
	Career Banding	• one or few structures, • few ranges (4 or less), and • no or extremely wide ranges (150% or more)
	Market Pricing	• separate ranges for each distinct type of job, as defined by the external labour market (jobs and ranges, however, may be grouped for ease of administration.), • the absence of a coherent structure (systematic relationships between different jobs), and • narrow pay ranges, to keep pay levels closely linked to external labour markets

In our experience, flexibility appears to be the more compelling reason because it permits the organization to have a larger pool of well trained workers when and if another person that has a critical skill is absent or otherwise unavailable to perform the necessary work. These reasons track well with the experiences of private sector organizations. In addition to reaping the benefits of a more flexible work force, the organization gets a way to encourage skill advancement and on the job learning. Employees, on the other hand, achieve increased pay.

Skill Based Pay Covers a Wide Variety of Occupational Groups

Skill based pay programs are in use in a wide variety of occupational groups. While the survey did not count the occupations, we found that they are in use among the following job families:

- building inspectors
- police officers
- engineers
- clerical
- fire fighters
- public works jobs
- social workers
- water and waste water treatment plant operators.

The characteristics that these jobs have in common are that the tasks and responsibilities can be broken into smaller, learnable skill blocks and the skills are, for the most part, observable. Management and other "knowledge workers" are noticeably absent from the list. Organizations interested in new pay models for these job families appear to be using broad banding instead of skill-based pay programs because of the subjectivity involved in determining skill block differences and certification.

What Is Skill Based Pay

Skill-based pay refers to a pay system in which pay increases are linked to the number or depth of skills an employee acquires and applies and it is a means of developing broader and deeper skills among the workforce. Such increases are in addition to, and not in lieu of, general pay increases employees may receive. The pay increases are usually tied to three types of skills:

- horizontal skills, which involve a broadening of skills in terms of the range of tasks
- vertical skills, which involve acquiring skills of a higher level
- depth skills, which involve a high level of skills in specialised areas relating to the same job.

Skill-based pay differs in the following respects from traditional pay systems which reflect skill differences in a structure consisting of rates of pay for unskilled, semi-skilled and skilled workers:

- Skill-based pay is a person-based and not a job-based system. It rewards a person for what he/she, rather than the job is worth. Job worth is reflected in a basic rate of pay for minimum skills, but pay progression is directly linked to skills acquisition (rather than to general pay increases applicable to all).

- It rewards (and therefore emphasizes) a broad range of skills which makes the employee multi-skilled and therefore flexible.
- It positively encourages skills development.
- A skill-based pay system may not necessarily reflect how well the skill is used, as this falls within the performance component of pay. But there is nothing to prevent injecting performance criteria into the system. In such cases "the system will be more performance-oriented than a structure", which merely recognizes different rates of pay for skills.
- The system needs to be underpinned by opportunities for training which is critical to the success of the system. The traditional structure is not dependent on such opportunities.

Reasons for Skill Based Pay

More than ever before in industrial relations history, a commonality of interests in the skills of employees has developed between employers and employees. Skills provide employees with a measure of protection against unemployment, as well as opportunities for higher earnings. At the same time, skills provide employers with an important means of achieving competitiveness.

Many countries today are seeking to advance to more technology and skill-based industries, while others have become (or are becoming) 'post industrial' societies, in which the application of knowledge determines productivity, performance and competitiveness. Comparative advantage based on, for instance, cheap labour or raw materials, has declined in importance relative to competitive advantage based on the ability to add value to a particular resource or advantage. Such comparative advantage partly (often largely) depends on people - their standards of literacy and education, work attitudes, value systems, skills and motivation. Critical today is the ability to innovate and develop clusters of competitive enterprises in particular industries. For the more industrialized countries, this means 'capturing' some of the key industries of the next century - micro-electronics, biotechnology, new materials, science industries, telecommunications, civil aviation, computers and software, robotics and machine tools and entertainment. An employee with skills is most flexible and productive, when he develops a broad range of skills, he is able to learn the next higher skill, develop analytical skills and is also able to work in a team. Important aspects of today's skills package include multi-skills, cognitive skills, interpersonal and communication skills, positive work attitudes and quality consciousness. Training is no longer only for current competence, but is also to prepare for the next stage of skills. Thus, pay systems which promote current and future skills, needs are increasing in importance among employers.

The impact of rapid technological change, the increasing globalization of product markets, greater customer choice and the emphasis on quality necessitate a frequent updating of skills, and flexibility to respond to rapid changes in the requirements of markets. A flexible workforce, which is one that is multi-skilled, ensures that production is not interrupted due to the narrow skills of workers, and that workers are themselves responsible for the quality of products.

Introducing a Skill-based Pay System

Introducing a skill-based pay system requires several steps to be taken and several issues to be addressed:

- The skills requirements of the enterprise should be analysed.
- The availability of resources for training should be ascertained.

- The jobs to be covered by the scheme should be identified.
- The individual jobs have to be grouped into 'job families' on the basis that in each 'family' the skills needs are similar. The skills within each job family and the tasks needed to perform the job should be analysed.
- The above will lead to an identification of the skill blocks or levels. The skill level is the pay grade relative to the competence to use particular skills, and the skill block is the training input which has to be completed to the satisfaction of the certifying authority in order to gain entitlement to the extra pay. It is not unusual for skill levels to consist of several skill blocks, each to be acquired through training.
- Training modules have to be formulated.
- The way in which certification is obtained that the skill has been acquired should be agreed upon.
- The base rates for 'job families' have to be set, as well as the payments that will be made thereafter when an employee moves upwards through the skills route.
- The criterion for extra payment is not acquisition of the skill, but its application.
- The period during which the skill should be applied before a new one is acquired should normally be decided on, as the skill should benefit the employer who should receive a return on the investment made.
- A difficult question is how obsolete skills should be dealt with e.g. through retraining or redundancy.

Problems in Skill-Based Pay

There are several problems associated with the introduction of skill-based pay which should not be underestimated. They can be extremely costly having regard to:

- the extra payment involved
- training costs
- the fact that some skills may be paid for, but used infrequently
- the possibility that unusable skills may be acquired unless the system is properly administered
- the fact that it is not always easy for an employer to anticipate accurately what skills will be needed in a few years' time.

The administration of the system is complex, both in regard to certification of skills acquisition and payment. Therefore, unless administered properly, the costs can outweigh the productivity and flexibility gains. Further, the employees who reach the maximum of the skill levels can be demotivated when extra payments, as distinct from general pay increases cease. Therefore, the gains from flexibility, improved quality, the elimination of some jobs and so on depend on the employer's ability to administer the system properly, making clear also that it is not the acquisition of any skills, but agreed skills, that fall within the scope of the scheme. Hence, the need to negotiate the system. It is easier to introduce skill-based pay in an entirely new (greenfield) site, than in an already existing one, where there is in existence a pay system based on different criteria.

Factors for Success

Some of the circumstances which contribute to the success of skill-based pay are:

- the employer's commitment to continuous training and development
- the value attached by the employer to personal growth and encouragement of a learning orientation
- dismantling strong bureaucratic hierarchies and narrow job demarcations
- participative management practices, independent and co-operative forms of work.

Skill-based pay systems are most appropriate to enterprises which depend on a high level of skills, and in which labour costs represent a relatively small portion of total costs, unlike in labour intensive industries. Though such pay systems have been commonest in manufacturing organizations, they are applicable to service industries as well, though the objectives may differ. In banks and airlines, for example, skill-based pay can be used to encourage people to work in areas where manpower is most needed at a given point of time due to customer flows. Skill-based pay is particularly consistent with knowledge-based work.

Among the advantages of skill-based pay are the following:

- It contributes to job enlargement and enrichment by breaking down narrow job classifications.
- Flexibility is increased by encouraging the performance of multiple tasks. It enables job rotation, and filling of temporary vacancies due, for instance, to absenteeism. It therefore contributes to a leaner workforce.
- It enhances productivity and quality through better use of human resources.
- It facilitates technological change, which may meet with resistance in a purely job-based system.
- The higher pay levels, continuous training, and job enlargement through the broadening of skills, tend to reduce staff turnover.
- Elimination of unnecessary jobs can result from a workplace having broad, rather than narrow skills. It also reduces the need for supervision.
- Job satisfaction is engendered through employees having greater control over the planning and implementation of their work.
- Broadening of skills leads employees to develop a better perspective of operations as a whole.
- It is an incentive for self-development.
- It provides employment security through skills enhancement.
- It reduces the need to look to promotion to higher levels (which are always limited) as the only way to enhance earnings, and it facilitates the planning of an employee's career development path.
- Since the reward flows from the application of a skill and it does not reduce opportunities for others to similarly increase their skills and earnings, there is likely to be less competition among individuals.

- Since the pay increases on account of skills are linked to a measurable standard, the criticism of subjectivity often associated with performance appraisals and individual-based performance-related pay, is avoided.

COMPETENCY-BASED COMPENSATION PROGRAMME

Performance and skill-based pay systems need to be negotiated and introduced at the enterprise level. Other than for very broad policy issues (e.g. whether such systems should be introduced), performance and skill-based pay cannot be negotiated or designed at the macro, or even at the industry level. It follows therefore that it is not possible to recommend a particular system which could be introduced across several enterprises or even across an industry. This is evident from the following steps that need to be taken before introducing such a scheme:

- A pay expert, or the management, would have to first analyze the existing pay structure.
- The business objectives of the enterprise and its overall human resource management policies should be determined.
- The objectives of the system to be introduced should be clearly identified.
- Whether the scheme to be introduced fits with the overall corporate and human resource management objectives of the enterprise has to be ascertained, as they must all 'fit' together.
- The scheme should be negotiated, and employees consulted to ascertain whether the desired objectives are likely to be achieved.
- Mechanisms to monitor and review the scheme should be agreed upon.

The principles outlined herein could help to guard against possible pitfalls and to identify some of the procedures to be followed, as well as to assist to some extent, in the making of choices between different schemes which may be introduced to achieve the objectives. No blueprint can be provided, however, though the principles can facilitate in identifying the types of schemes suitable to particular types of businesses and tasks.

DIAGNOSIS AND BENCHMARKING

Diagnosis bench-marking: It is defined as a method of defining standard job that is used to anchor the employer's pay scale and around which other jobs are arranged in order of relative worth. The relative worth of bench-mark job is determined with the help of job evaluation. These benchmark jobs are used by the employer's for salary survey.

The main objective of defining the benchmark jobs are to:

- Recruit, reward and retain talented staff.
- Recognize staff's value and their contributions.
- Reward staff for performance.
- Manage pay through a simpler, more flexible and less bureaucratic system.
- Ensure fair and consistent administration.
- Analysis and identification of jobs against consistent criteria and measures them in a uniform and objective manner.

The benchmark or standards of which the plan is to be based should be effective and should satisfy these conditions:

(i) Standards or benchmark jobs are viewed as fair by superiors & subordinates.

(ii) They should be reasonable.

(iii) They should be specific.

(iv) They should be complete and focus on quality rather than quantity.

The compensation surveys are very helpful in providing benchmarks and building databases. Human Resource departments of most mid-sized and large corporations have worked hard to enhance their knowledge and skills in designing appropriate compensation models. Compensation system has started reflecting higher levels of discrimination, and large variation in pay packages which are now accepted by managers in many corporations and professions. Salary or compensation surveys can be formal or informal. Informal telephone or internet surveys are good for checking on a relatively small number of early identified and quickly recognized jobs, such as when a HR director of a bank wants to confirm the salary at which to advertise a newly open cashier's job. Such internet based survey is know or wage access compensation survey, that provides employer with the current and accurate compensation information needed to attract and retain quality employees. It contains over 500 benchmark positions. Each position includes a detailed job description to ensure a comparable match during the survey data entry process. Survey results are calculated based on the criteria selected and are displayed as mean, weighted mean, median, average low and average high rates of pay.

The degree of match between the survey benchmark jobs and each company's benchmark jobs assessed by various means. The Hay group has installed the same job evaluation plan in many companies that participate in its surveys. Consequently jobs in different organizations can be compared on their job evaluation points and the distribution of points among the compensable factors.

Benchmarking Jobs

Managerial Group	Technical Group	Manufacturing Group	Administrative Group
		Assembler I Inspector I	
Vice Presidents	Head/Chief Scientist	Packer	Administrative Assistant
Division General Managers	Senior Associate Scientist	Material Handler Inspector II	Principal Administrative Secretary
Managers	Associate Scientist	Assembler II	Administrative Secretary
Project Leaders	Scientist	Drill Press Operator Rough Grinder	Word Processor
Supervisions	Technician	Machinist I Coremaker	Clerk/Messenger

Fig. 2.1

Uses of Compensation Surveys

1. To know what the competitors are paying.
2. Development of more integrated pay structures covering all categories of employees.
3. Extent flexible benefit schemes.
4. Align pay strategy more systematically with business strategy.
5. Treat employees as stakeholders who have the right to be consulted on and involved with any reward management developments.
6. Achieve the integration of reward and other HR processes and practices for example, human resource development.
7. Use variable pay rather than consolidated pay increases.
8. Examine more rigorously the cost effective schemes of payment.
9. To analyze pay related problems.

Characteristics of a benchmark job:

1. It's contents are well-known and relatively stable over time.
2. The job is common across a number of different employers. It is not unique to a particular employer.
3. A sizable proportion of the work force is employed in this job.

A representative sample of benchmark jobs will include the entire domain of work being evaluated – office, administration, technical, manufacturing and so on, thus helping to ensure the accuracy of the decisions based on the job evaluation. That means a job evaluation plan is developed using benchmark jobs and then the plan is applied to the remaining non-benchmark jobs to match with jobs at competitors that use a traditional job-based approach. Market data must be converted to fit the skill or competency structure. The simplest approach is to identify the lowest and highest paid benchmark jobs for the relevant skills in the relevant market and to use the wages for these jobs as anchor for the skill based structures; work at various levels within the structure can then be slotted between the anchors.

INFLUENCE OF PAY ON EMPLOYEE ATTITUDES AND BEHAVIOUR

Because compensation practices heavily influence recruitment, turnover, and employee productivity, it is important that applicants and employees view these practices in a favourable light. In the following section, we discuss how people form perceptions about a firm's compensation system and how these perceptions ultimately affect their behaviour.

One would expect that an individual's satisfaction with his or her compensation would simply be a function of the amount of compensation received: the higher the compensation rate, the greater the satisfaction. However, in reality things are not that simple. In fact, the amount of pay is less important than its perceived fairness or equity. To put this finding in perspective, consider the behaviour of many professional athletes when negotiating a new contract. The average NBA salary in 2003 was $4.9 million; the average baseball salary was $2.4 million; the average NFL salary was $1.3 million. Yet, ball players continue to ask for more money. In many instances, these demands stem from neither need nor greed. Rather, the demand for greater salaries often stems from perceptions of inequity. For instance, despite a $15 million salary, a player may feel that his pay is inequitable because a less capable player (or someone he perceives as being less capable) is earning an equal or greater salary.

Regarding the returns they get (e.g., pay) for the work they perform. People judge the equity of their pay by comparing their outcome-to-input ratio (O/I) with another person's ratio. This comparison person is referred to as one's "referent other." People feel equity when the O/I ratios of the individual and his or her referent other are perceived as being equal. A feeling of inequity occurs when the two ratios are perceived as being unequal. For example, inequity occurs if a person feels that he or she contributes the same input as a referent other, but earns a lower salary.

A person's referent other could be any one of several people. People may compare themselves to others:

- Doing the same job within the same organization
- Working in the same organization, but performing different jobs
- Doing the same job in other organizations.

For example, an assistant manager at a Wal-Mart department store might compare her pay to other assistant managers at Wal-Mart, to Wal-Mart employees in other positions (either above or below her in the organizational hierarchy), or to assistant managers at Kmart department stores.

While the mechanism for choosing a referent other is largely unknown, one study found that people do not limit their comparisons to just one person; they have several referent others. Thus, people make several comparisons when they assess the fairness of their pay; perceived fairness is achieved only when all comparisons are viewed as equitable. When employees' O/I ratios are less than that of their referent others, they feel they are being underpaid; when greater, they feel they are being overpaid. According to equity theory, both conditions produce feelings of tension that employees will attempt to reduce in one of the following ways:

1. Decrease inputs by reducing effort or performance.
2. Attempt to increase outcomes by seeking a raise in salary.
3. Distort perceptions of inputs and/or outcomes by convincing themselves that their O/I ratio already is equal to that of their referent other.
4. Attempt to change the inputs and/or outcomes of their referent other(s). For example, they may try to convince their referent other(s) to increase inputs (e.g., work harder for their pay).
5. Choose a new referent other whose O/I ratio already is equal to their own.
6. Escape the situation. This response may be manifested by a variety of behaviours, such as absenteeism, tardiness, excessive work-breaks, or quitting.

While equity theory poses six possible responses to inequity, only two of them typically occurs. Research findings, for example, have linked underpayment to increases in absenteeism and turnover and to decreases in the amount of effort exerted on the job. These linkages are especially strong among individuals earning low salaries.

Contrary to equity theory's predictions, these responses occur only when employees believe they are underpaid. Overpaid individuals do not respond because they feel little, if any tension, and thus have no need to reduce it. (The research findings on the issue of overpayment find overpayment to be either just as satisfying as equity, or somewhat dissatisfying but not nearly as dissatisfying as underpayment.) When feeling underpaid, why do some people choose to decrease their inputs, while others choose to escape the situation? A recent study sheds some light on this issue. The study found that reaction to inequity depends on the source of the comparison; people react differently depending on whether they judge equity on the basis of external (referents outside of the organization) or internal (referents employed by the individual's own organization) comparisons. When perceptions of inequity are based on external comparisons, people are more likely to quit their jobs. For instance, a nurse working for Hospital A may move to Hospital B if the latter pays a higher salary. When based on internal comparisons, people are more likely to remain at work, but reduce their inputs (e.g., become less willing to help others with problems, meet deadlines, and/or take initiatives)

KEY TERMS

Pay grade	Range spread
Pay structure	Broadbanding
Pay compression	Bench-marking

SUMMARY

The present competitive environment requires new strategies toward employee compensation, new management and employee practices, and new methods of educating employees to the shifting competitive environment that has brought about the necessity for these changes. Careful attention must be placed on the development of reward systems that reflect the financial capability of the company as well as reinforce the new directions associated with contemporary organizational strategies. Thus, compensation decisions should be fully integrated into the organization's business and operations strategy, through its compensation philosophy.

Strategic pay. "Pay structure has strategic value that assigns different pay rates offer jobs of different values which differentiate individual employee contributions. A well designed pay structure is one which attract and retain potential employees.

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Technical considerations for pay structure design include the number of range levels, width of the ranges from minimum to maximum values (i.e., range spreads), the distance between adjacent range midpoint values (i.e., midpoint differentials), and the degree of overlap between adjacent ranges.

The "range spread" is a characteristic of salary structures that describes the distance between the minimum and the maximum salary range Traditional Structures Many salary ranges that have narrow range spreads, small midpoint differentials, and broad overlap between adjacent ranges characterize traditional structures. Traditional structures tend to place greater emphasis on internal equity, as opposed to external equity. Traditional structures focus on job content evaluation to arrange a job worth hierarchy.

Broadbanding: It is a method of grouping jobs and determining pay that makes compensation administration more flexible and more responsive to the needs of changing organizations. Broadbanding eliminates the present hierarchical grading structure and narrow salary ranges. Pay compression can occur when the pay rates of several employees, despite clear differences in capability, are in a cluster.

Skill-based pay refers to a pay system in which pay increases are linked to the number or depth of skills an employee acquires and applies and it is a means of developing broader and deeper skills among the workforce. The pay increases are usually tied to three types of skills:

- horizontal skills, vertical skills, and depth skills

Diagnosis and bench-marking: It is defined as a method of defining standard job that is used to anchor the employer's pay scale and around which other jobs are arranged in order of relative worth.

REVIEW QUESTIONS

1. Why would an organisation use more than one pay structure? Describe some factors that influence the design of a pay structure.
2. Explain some issues underlying overlap between pay grades?
3. What is a benchmark or a key job? Why are these jobs so critical in various job evaluation methodologies.
4. Justify the high remuneration paid to executives. What steps can be taken to remedy this situation.
5. Bring out the differences between executive remuneration and wages of workers.

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MANAGING COMPENSATION

3

LEARNING OBJECTIVES

After studying this chapter, you will be able to understand —

- ⇨ Designing a compensation system
- ⇨ Internal and External eauity in compensation system
- ⇨ Compensation as a retention strategy
- ⇨ Competency based programme
- ⇨ Framework of compensation policy

DESIGNING A COMPENSATION SYSTEM

Employers receive compensation from a company in return for the work performed. Most people think the pay and compensation to be the same, but the fact is compensation is much more than just the monetary rewards provided by an employer. According to Milkowitch and Newman, "compensation is all forms of financial returns and tangible services and benefits employees receive as a part of an employment relationship". The phrase "financial returns" refers to an individual base salary, as well as short and long term incentives. Tangible services and benefits are such things such as insurance, paid vacations and employer discount.

Any organization's compensation practices and designing have far reaching effects on its competitive advantage. According to Richard Henderson, 'To develop a competitive advantage in a global economy, the compensation program of the organization must support totally the strategic plans and actions of the organization. An organization compensation system can help to reinforce the key corporate values and facilitate the achievement of organizational objectives. It is important to give a lot of consideration to our business compensation structure because it ultimately reflects how employees are valued.

A host of laws such as The Equal Pay Act, Fair Labour Standards Act, and The Employment Retirement Income Security Act, regulate corporate compensation practices. Some pertain to pay issues such as discrimination, minimum wages and overtime pay, others pertain to benefits, such as pensions, unemployment compensation and compensatión for work related injures. An organization must understand and fully follow these laws in order to avoid costly lawsuits and design a competency based compensation structure.

The key in designing any compensation is to develop the understating of the forms, vision and direction. As well designed compensation plan becomes one of many tools, a firm can use to help reach its strategic goals. Any failure in compensation design leads to failure to motivate any employee.

A guideline for designing a compensation plan begins at the top by examining the better strategy and ends with a model that is ready to be implemented. There are various steps that help as organization to design a performance based compensation strategy and prepare the organizations disign. Inadequate use of incentive plans and problems with compensation design and strategy often fails to motivate performance of an employee.

Behavioural scientists, employee and management surveys experience show that compensation can be a strong driver of employee behaviour under the right circumstances when properly designed. Also in jobs where significant variability in pay occur in compensation and when it is closely related to key performance factor, then pay can be a big motivator.

The good performers prior to new compensation plan implementation remain good performers and may not improve much because they are already giving close to 100% effort, but the middle and the bottom performers are where there is significant opportunity for change.

(1) Focusing on the strategy objectives

The most important goal in designing an compensation system is supporting the strategic objectives of the organization and ensuring the system that fit in with the organization structure and strategy. There are various questions which should be focused before designing compensation strategy such as:

- What is the rate and mission of the organization?
- Why does it exist?
- What are the strategic goals and objectives for the next five years?
- Whether current employee have the skills to meet these objectives? If so, will they be rewarded for having them? If not, will internal candidates be trained to gain skills or will the organization recruit externally to fill the goals?
- What is the organization's strategy?
- Do employees work individually or in teams?
- Are employees seen as costs or investments?
- What is the cost to replace employees?
- What is the desired turnover rate?
- What should the organization's compensation plan accomplish?
- How would you describe the current total compensation package, including benefits retirement time off etc., at the organization?

- How does it compare with that of other employees in the market. What should the organization pay in relation to the market?
- What is the appropriate balance between external market equity and internal worth.

Once there is an understanding of the answer to these questions, the compensation can be developed, policy guidelines are prepared which reflects thinking, values, strategies and the company is set inconsistency by top management.

(2) Ensuring commitment through communication and participation

An organization must plan for making change to its compensation system.

Before beginning to tackle something, it is important that executive management is absolutely committed to the process, the result and the implementation. All important techniques for participation and communication by the clearly defined, advisory or steering committee. A compensation review committee could help identifying current issues with compensation, job clarification or salary administration. It could contribute ideas and feedback provide valuable advice.

(3) Analyzing job functions

A job analyst develops a current and thorough understanding of the work that is being formed by the employee. It is important to undertake a job analysis before making changes to the compensation plan as job analysis provides a collection of relevant information on the type, scope and responsibility of each job. It is the foundation for job description and how they are in the market. It enables the organization to establish baseline information about a job level of responsibility and qualification, and to compare it to the market place. It also ensures and documents our compliance with legal requirement.

(4) Writing job description

Once the information is collected through the job analysis process, it can be used for preparation of job description. A job description summarizes the important component like the general nature of the work, specific tasks, responsibilities and outcome competence required to perform the job. A written job description should be considered a final document. Before it is finalized, it should be received and accepted by both the employee and the supervisor.

(5) Determining internal pay equity

It determines fairness within the organization. Fair pay is pay that employees generally view as equitable. Internal equity is determined by job evaluation techniques such as whole job ranking method and factor comparison technique.

(6) Determining external pay equity

It is the perceived fairness in pay relative to what other employees are paying for the same type of labour. An externally focused job evaluation method includes the market pricing slotting method. For maximum flexibility, using market pricing is recommended to that of market competitive pay rates. Market competitiveness is more flexible and adaptable than other methods. To gather competitors pay rates, a survey method is developed which includes the following steps:

- Establish a timeline
- Select bench-mark positions to survey

- Target survey participants
- Design questionnaire
- Use other available market data sources
- Follow up and verify answers with participants.

(7) Designing salary structure

Once collection of market data and determination of a hierarchical ordering of position, is done a salary structure can be designed. Salary structure consists of jobs of equal value that are grouped into grades with competitive salary ranges. Pay ranges are the rates from the minimum to maximum of each grade. Positions are assigned to grades and pay ranges based on job content, marketing or external equity and internal equity. Each salary range includes minimum, midpoint and maximum salaries, with the midpoint representing the market or going rate for the job.

Typical compensation design problems includes:

- Failure to tie pay closely to achievement of objective and realistic performance measures.
- Failure to regularly measure and provide feedback on performance.
- Failure to design variances in pay-related to performance that are large enough to be perceived by the employer as worth the effort.
- Over reliance on salary as the only significant method of financial rewards.

Equity in Compensation

Equity means fair pay treatment for employees, which helps to attract, motivate and retain competent employees because equity is such an important concern. Individuals responsible for developing a firm's compensation system need to understand how perception of equity are formed. Equity theory, formulated by J. Stacy Adam attempts to provides such an understanding. The theory states that people form equity beliefs based on two factors:

(i) Inputs

(ii) Outcomes

(i) Inputs refers to the perception that people have concerning what they contribute to the job (e.g., skills or efforts)

(ii) Outcomes refer to the perception that people have regarding the returns they get (e.g., pay) for the work they perform.

People judge the equity of their pay by comparing their O/I (output to input rates with another person ratio. This comparison person is known as 'Referent other'Equity is believed by an individual when his or her O/I ratio is equal to the O/I ratio of the referent.

The referent person can be either–

(i) Doing the same job within the same organization.

(ii) Working in the same organization, but performing different jobs.

(iii) Doing the same job in other organizations.

Any feelings of inequity (underpaid or overpaid) from the referent person produce feelings of tension and frustration that employees will attempt to reduce in one of the following ways:

- Decrease input by reducing effort or performance.
- Attempts to increase outcomes by seeking a raise in salary.
- Distract perceptions of inputs and/or outcomes by convincing themselves that their O/I rates already is equal to that of their referent other.
- Attempt to change the inputs and/or outcomes of their referent others.
- Choose a new referent whose O/I ratio already is equal to their own.
- Escape the situation.

This response may be manifested by a variety of behaviour such as absenteeism, tiredness, excessive work-break or quitting.

These response occurs only when employee believes that they are underpaid or overpaid. Individuals do not respond because they feel little tension and don't want to reduce it.

Thus, it is concluded that employees will feel equity when they perceive that.

(i) Their pay is fair, relative to the pay received by worker in other organization who holds similar position (external equity or external competitiveness).

(ii) Fairly reflects their input to the organization (employee contributions).

Achieving Internal Consistency/Internal Equity

Internal equity refers to the pay relationship among different jobs/skills/competencies within a single organization. To achieve internal consistency, firm's employees must believe that all jobs are paid what they are "worth". In other words, they must be confident that company pay rates reflect the overall importance of each person's job to the success of the organization. For the pay rates to be internally consistent, an organization first must determine the overall importance or worth of each job. It is determined by the process of job evaluation. In general, the evaluation is based on "informed judgments", regarding such things as the amount of skill and effort required to perform the job, the difficulty of the job, and the amount of responsibility assumed by the job-holder. It is used to measure relativities and determine where the job should be placed in a pay structure (the rate for the job). Relative job size assessed in terms of inputs (knowledge and skills), process (behavioural requirement involving the use of competencies) and output (the level of responsibility for result and the impact the job makes on team or organizational performance). Most firms creates a committee of individuals, called job evaluation committee, for the purpose of making the evaluation. The committee members typically include department managers, vice president, plant manager and HR professionals. The committee chair usually is an HR professional or an outside consultant.

Perhaps, the two most serious problems with job evaluation ratings are subjectivity and the rapidity with which jobs fundamentally change, both of which can cause inaccurate and unreliable ratings in order to minimize subjectivity, the rating scales used to evaluate jobs must be clearly defined and evaluators should be thoroughly trained on how to use them. Moreover, the evaluators should be provided with complete, accurate and up-to-date job descriptions.

When job evaluation have been completed, jobs are grouped into pay grades based on the total number of points received (point method). Jobs with the similar or same point values are placed in the same grade. Once the jobs are classified into grades, all jobs within the same grade are treated alike for pay purposes that is, the same range of pay applies to each job in a grade. As companies develop pay grade system, they must decide how many pay grade to establish. Most firms use thirty to fifty pay grades. However, some use as much as one hundred or more, while others use as few as five or six. The practice of limiting number of grades eases the firm's administrative burdens.

Determining External Pay Equity

It is the received fair in pay, relative to what other employees are paying for the same type of labour. An externally focused job evaluation method includes the market pricing setting method. For maximum flexibility using market pricing is recommended to that market competitive pay rate. Market competitiveness is more flexible and adoptable than other methods. To gather competition pay rates, a survey method is developed

A firm achieves external competitiveness when employees perceive that their pay is fair in relation to what their counterparts in other organizations earn. To become externally competitive, organizations must first learn what other employers are paying and then make a decision regarding just how competitive they want to be. They then establish pay rates consistent with this decision. Following is an elaboration of how these steps are carried out:

1. The firm begins by conducting or acquiring a salary survey. This survey provides information on pay rates offered by a firm's competitors for certain bench-mark jobs (i.e., jobs that are performed in a similar manner in all companies and can thus serve as a basis for making meaningful comparisons). Some firms gather this information from existing surveys already conducted by others, such as those produced by the Bureau of Labour Statistics. Trade associations also conduct surveys routinely for their members, or companies may hire consulting firms to gather such information. Salary surveys conducted by others should be used when they contain all the information needed by the company in question. When no such surveys exist, companies generally conduct their own.

2. After the pay practices of other companies have been identified, the organization must determine how competitive it wants to be (or can afford to be). Specifically, it must set a pay policy stipulating how well it will pay its employees relative to the market (i.e., what competitors pay for similar jobs). The determination of a pay policy is a crucial step in the design of a pay system. If pay rates are set too low, the organization is likely to experience recruitment and turnover problems. If set too high, however, the organization is likely to experience budget problems that ultimately may lead to higher prices, pay freezes and layoffs.

3. The majority of firms pay at the market rate, which is the rate offered by most of the competitors for labour. Those paying above market are referred to as "market leaders." These typically are companies with the ability to pay and the desire to attract and retain top-notch employees (e.g., "cream of the crop"). Those paying below market ("market laggards") generally do so because they are unable to pay higher salaries. Such companies often attempt to attract employees by linking pay to productivity or profits, so that the employees can earn more if the company does well.

4. When setting its pay policy, a company must consider its strategic plan. For example, if long-term employee commitment is a strategic goal, then the organization should attempt to develop compensation strategies that will enhance retention, such as establishing a generous retirement plan for long-service employees or adopting a profit-sharing system tied to tenure.

5. Once market rates for jobs are determined and a pay policy is established, an organization must price each of its jobs. Since market rates identified by a salary survey usually are restricted to bench-mark jobs, how do organizations determine these rates for their non-benchmark jobs? Using the data collected on the bench-mark jobs, an organization would determine the statistical relationship (i.e., simple linear regression) between job evaluation points and prevailing market rates. This regression line is referred to as the pay policy line. The appropriate pay rates for non-bench-mark jobs are set based on this line.

Achieving Employees Contribution Equity

Employees contribution equity is achieved when employees believe their pay fairly reflects their level of contribution to the organization. To achieve this aim, an organization must first establish a range of pay for each pay grade; it must then place each employee within that range based on his or her contribution to the organization.

A pay range specifies the minimum and maximum pay rates for all jobs within a grade. When establishing pay ranges, most employers set the market rate at the midpoint of the range. The spread from the midpoint usually varies, becoming larger as one progresses to higher pay grades. Most organizations establish a range spread of 10-25 percent for office and production work, 35-60 percent for professional and lower-level management positions, and 60-120 percent for top-level management positions.

The mechanism for recognizing employee contributions differs for new and existing employees. Contributions made by new employees are recognized by varying the level of starting pay they receive. New employees usually are paid at the minimum rate unless their qualifications exceed the minimum qualifications of the job. Those exceeding minimum qualifications are paid more because they can make a greater contribution, at least initially. Existing employees' contributions usually are recognized in the form of pay raises, typically granted on the basis of seniority and performance.

One may conclude that employees will believe their pay is equitable when they perceive that it:

- Is fair relative to the pay received by co-workers in the same organization (internal consistency).
- Is fair relative to the pay received by workers in other organizations who hold similar positions (external competitiveness).
- Fairly reflects their input to the organization (employee contributions).

COMPENSATION AS A RETENTION STRATEGY

Compensation plays a very important role in retaining potential employees. Implementing compensation and benefits programs that reward the right behaviour and performance will help attract the right people to the organization, and will also help the best people to become more productive. There are various key learning retention strategies that company must incorporate to retain top talent and remain competitive in the current labour market. It is important to search key areas that are important to the organization's employees in terms of compensation and benefits. Mapping this information into the overall plan and budget of the organization ensures that salary and benefits program add value to employees and the organization.

Total compensation includes a total rewards approach because monetary compensation is not always the only factor that employees consider when evaluating a job. Compensation professionals must be very aware of the many elements in addition to money. Our global economy has become more apparent that these different elements, approaches, techniques and tools should be used while designing the compensation plan.

Some of the key learning strategies of retention that defines compensation role are:

- There should be an effective performance management system that compensation employees fairly in addition to above market pay, employee's seek flexible work schedule, opportunities for advancement, an enhancement in profits and operations of the organization.
- Managing poor performance is just as important as reorganizing good performance, as non-performers can demotivate good employees.
- Terms and conditions for designing compensation are not key to a retention strategy as they are perceived as competitive with the market and equitable among employees. The organization should regularly benchmark its salaries and benefits and communicate to employees that their salary and benefits are distributed in a fair and equitable manner.
- Hiring and promoting the right people ensures company's success and helps in achieving organization's business strategy.
- Promotion provides employees with a motivating factor to remain in the organization and to be productive.
- Career development motivates employees and also allows them to build for promotion.

COMPETENCY BASED PROGRAM

"Skill is nothing but a mere hoard of gold, till it is set to work."

Competencies are knowledge, skills and attitude (KSA) and most importantly behaviours that enables one to perform a job that correlates with performance on the job, that can be measured against well accepted standards and that can be improved via training and development. Competencies effectively translate the strategic vision and goal of the organization into behavioral actions. Competency based compensation system focuses on the skills and knowledge required to do a particular job in addition to the attitude and ability to do the job.

Competency-based models help in the organization to:

1. Drive business results.
2. Retain key talent.
3. Raise the bar of individual and organizational performance.
4. Integrate cultures following a merger.
5. Increase in competitive advantage.

Human capital is the most important resource for any organization in the globalized and skill based economies around the world. It is important for any organization to align the employee behaviour to the strategic objectives for sustained success.

Competency based Human resource Management is being increasingly recognized as effective way of talent management over the previously adopted job-description related approach. It involves a transition from the traditional way of managing human resources based on what people have (qualifications) to what people can do (performance).

The advantages of using the competency based framework for Human Resource sub-systems such as selection, promotion, training and developmentper formance management, career and succession planning, compensation, etc. are:

- Provide a systems approach to human resources activities and make them more effective.

Competency modelling is based on the fundamental belief that every employee should be given the opportunity to do his or her best. It provides both the structure and discipline to help bring out the best effort in people and ultimately the best performance for the organization. Today's competitive marketplace, constant change, the need for the most cost-effective approaches and potential labour shortages are driving organization to implement new competency based approaches to drive higher performance. As more employers recognize the economic value of multi skilled employees who can work as a team, they are rethinking traditional, job based pay programs that don't fully support skill development or achievement of results. Compensation strategies and programs are changing dramatically and the competency based approach to pay is quickly gaining adherents. It develops the critical behaviour and abilities employees need to achieve specific business results. By linking compensation directly to individual contributions that make a difference to the organization, a company can also maintain company's philosophy related to how equity-based compensation will be distributed within various levels of the company.

- The company's philosophy relating to the dilution of existing equity owners. In this, the company uses equity-based tools in its compensation program and articulate how the company will address the issue of dilution.

- The parameters by which the company will use severance packages, if at all. The policy should include a definitive statement related to how the company views severance agreements.

Competencies bring out the synergy between different sub-systems by reinforcing each other and minimize the needless overlaps and contradictions if they were treated independently.

- Provide a common language to Human resource activities for easy implementation.
- The competency based approach to Human Resource Management helps people understand this aspect much better by providing an organization-wide common language to understand different roles and responsibilities and how they can grow to fulfill their aspirations.
- Provide management a view of available and required competency level. The competency based form work helps in identifying the interventions needed and in what form to achieve this strategic objective.

Many organizations are using competencies as the means for identifying and developing talent. Unless the competency framework is well planned and defined, organizations will not have the proper foundation for developing and implementing a system of human resource programs and initiatives for renewal and sustained success.

The importance of competency based HRM is increasingly being accepted as an explanation of superior performance. This is based on the fact that the performance of an employee is based on not only skills or knowledge, but is also a function of internal and external environment. From the Indian context, companies are increasingly becoming aware of the importance and an article on "competency profiling" in Business Today (1999 July), reported the steps Indian Organizations are taking with respect to competency based HR practices.

Research in 1999-2000 by three leading performance management companies worldwide, indicate that competency based practices are an integral tool for "talent management", shareholder return and value creation. It is found that companies using competency based HR programs returned between 20-30 percent, more to shareholders than companies using the traditional method (job description, salary grades). Some of the companies using competency based practices are L & T, Smithkline, Pepsico, Escort, P & G, Xerox, Mahindra & Mahindra, etc.

FRAMEWORK OF COMPENSATION POLICY

A compensation framework supports a long term strategic vision for compensation and implements new initiatives, provides the needed direction and innovative concept towards solving special salary problems. The shift from the traditional compensation system to new flexible system increases delegation to managers, focus on long term approach to compensation management, eliminates duplication and increases efficiency.

Objectives of Compensation Policy

- To ensure that compensation is maintained at the desired competitive level by taking into account changing market conditions, and in particular the prevailing market wage rate.
- Attract and retain the desired quality mix of employees so as to achieve the company's objective.
- Motivate employees to perform their duties and responsibilities to the best of their abilities.
- Ensure an equitable compensation system.
- Integrating compensation with other areas of human resource management to emphasize on transparency, monitoring, reporting and accountability.
- Creating and maintaining an organizational structure and culture that facilitates both employee and organizational performance.
- To provide broad guidelines by which company uses alternative form of compensation and the relative weight in relation to overall compensation if "other" forms of compensation will be utilized (Pension's benefits, perks, loans, etc.).

A good rewards and remuneration system ensures that each person receives appropriate financial and non-financial recognition to account for the personal contribution they are making and the overall value of their position to the organization. If the rewards are not fair and equitable, dissatisfaction arises which leads to absenteeism and demotivation. Therefore, there is a need to develop a new structure or framework of compensation which can be tied to a completely new performance management approach, unloading better performance appraisal mechanisms. This includes:

1. Creating and maintaining an organizational structure and organizational performance.
2. Recognizing and rewarding individual and team performance, financially and otherwise, in relation to the overall contribution made.
3. Implementing compensation systems that fairly treat and recognize all employees, regardless of their level within the organization.
4. It involves matching remuneration with the contribution made.
5. A feedback loop between motivation and performance exists, which potentially impact each other.

An integrated system of compensation policy is as follows:

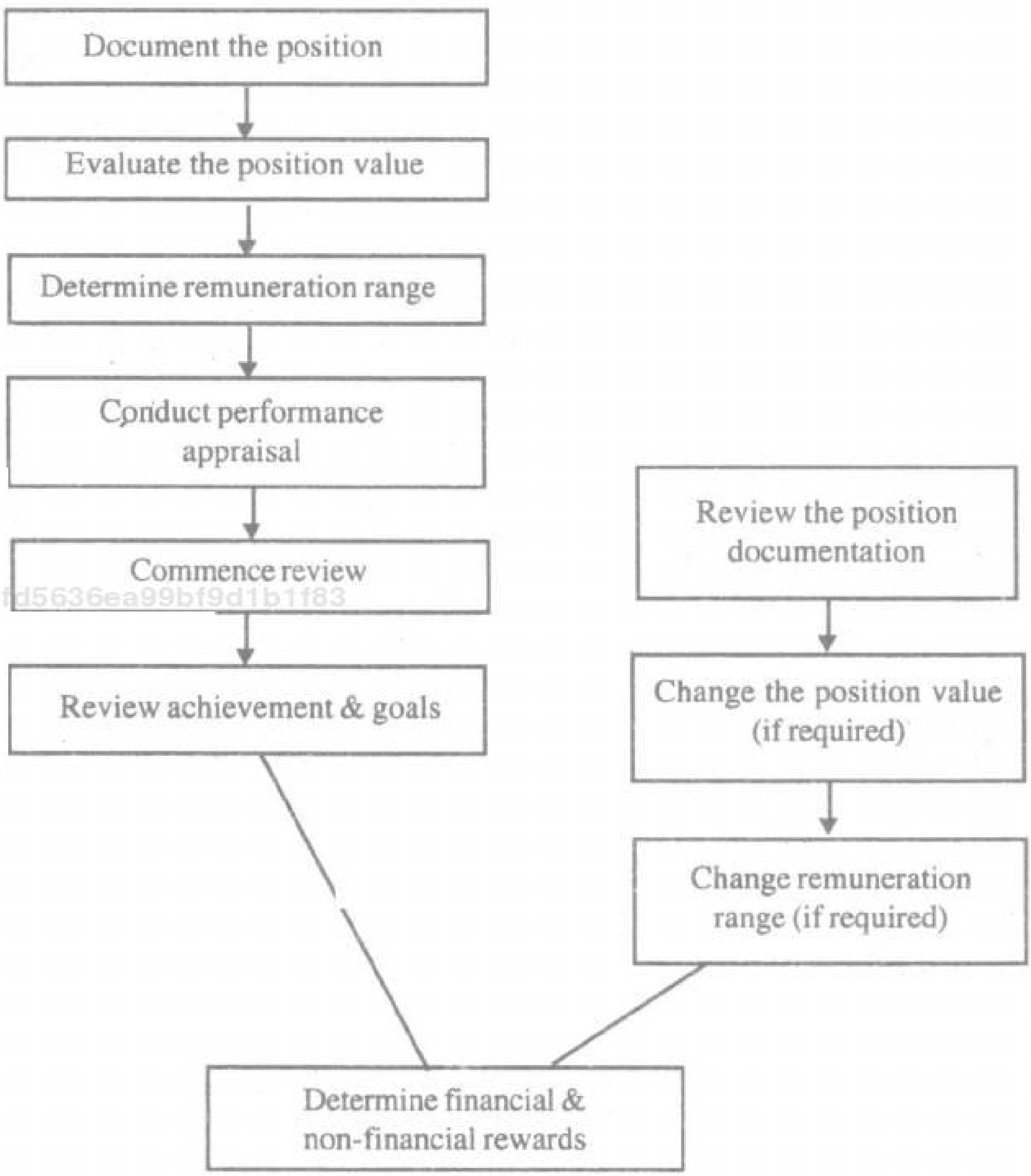

Fig. 3.1

Executive compensation policies should contain, at a minimum, the following components:

1. The bonus and long-term incentive compensation. The policy should clearly articulate how the company ensures optimal alignment of interests with shareowners through the design and implementation of its executive compensation program.
2. The company's intended forms of incentive and bonus compensation including what types of measures will be used to drive incentive compensation.
3. The policy should include the company philosophy related to the major components of incentive compensation, including the strengths and weaknesses of each and how the overall incentive component of the plan provides optimal alignment of interests with shareowners, Performance based plans should be constructed including the specific drivers to construct performance based plan.
4. The company's intended distribution of equity based compensation.

KEY TERMS	
Internal equity	Compensation framework
External equity	Salary structure
Competencies	

SUMMARY

The key in designing any compensation is to develop the understating of the forms, vision and direction. A guideline for designing a compensation plan begins at the top by examining the better strategy and ends with a model that is ready to be implemented. There are various steps–

(1) Focusing on the strategic objectives
(2) Ensuring commitment through communication and participation
(3) Analyzing job function
(4) Writing job description
(5) Determining internal equity
(6) Determining external equity
(7) Designing salary structure.

Equity means fair pay treatment for employees, which helps to attract, motivate and retain competent employee. Adams theory states that people form equity beliefs based on two factors —

(i) Inputs
(ii) Outcomes

(i) Inputs refers to the perception that people have concerning what they contribute to the job (e.g., skill and effort)

(ii) Outcomes refers to the perception that people regarding the returns they get (e.g., pay) for the work they perform).

Internal equity refers to the pay relationship among different jobs/ skills/ competencies within a single organization.

External pay equity is the received fair in pay relative to what other employees are paying for the same type of labour. Employee contributions equity is achieved when employees believe their pay fairly reflects their level of contribution to the organization.

Compensation plays a very important role in retaining potential employee.

Competencies are knowledge, skills and attitude (KSA) and most importantly behaviours that enables one to perform a job that correlates with performance on the job, that can be measured against with accepted standards and that can be improved via training and development.

Competency-based models help in the organization to:

- Drive business results.
- Retain key talent.
- Raise the bar of individual and organizational performance.
- Integrate cultures following a merger.
- Increase in competitive advantage.

A compensation framework supports a long term strategic vision for compensation and implements new initiatives, provides the needed direction and innovative concept towards solving special salary problems.

REVIEW QUESTIONS

1. What is more important for organizational effectiveness – internal equity or external equity?
2. Explain the importance of compensation as a retention strategy.
3. What steps can be a taken to design a competency based compensation program?
4. What are the factors responsible for the failure of a successful compensation program?

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PERFORMANCE BASED COMPENSATION

4

LEARNING OBJECTIVES

After studying this chapter, you should be able to understand —

- What is performance appraisal?
- Importance of performance apprasial system
- Effect of compensation on performance and motivation
- Pay for performance system
- Meeting the challenges of pay for performance system
- Types of pay for performance plan
- Does compensation motivate performance?

WHAT IS PERFORMANCE APPRAISAL?

According to Peter Drucker, "an organization is like a tune, it is not constituted by individual sounds but by their synthesis. The success of an organization will therefore depend on its ability to measure accurately the performance of its members and use its objectivity to optimize them as a vital resource."

Organization are run and steered by people. It is through people that goals are set and objectives are realized. The performance of an organization is thus dependent upon the sum total of the performance of its members. Performance appraisal refers to all those procedure that are used to evaluate the personality, the performance and the potential of its group members.

DEFINITION

Performance appraisal may be defined as a structured formal interaction between a subordinate and supervisor, that usually take the form of periodic interview – annual or semiannual, in which the work performance of the subordinate is examined and discussed, with a view of identifying weaknesses, strengths as well as opportunities for improvement and skills development.

Nikol defined Performance as

The outcome of behaviour: Behaviour is individual activity where outcomes of behaviour are the way in which the behaving individual environment is somehow different as a result of his or her behaviour.

Overview of Performance Appraisal:

- Ideally performance appraisal allows management to specify what employees must do, combines feedback and goal setting.
- Everyone involved needs to recognize that performance appraisal involve human judgment and information processing can never be totally objective or infallible.
- System should aim to be easy to operate, easy to explain, easy to maintain and, easy to administer.
- System should be job related, relevant, sensitive, reliable, acceptable, practical, open, fair and useful.
- Ratee should participate in the development.
- Need to take legal issues into account.

Importance of Performance Appraisal system

- An effective system of performance appraisal. helps the supervisor to evaluate the performance of his employees systematically and periodically. It helps in the placement of the employees on the job for which they are best suited.
- Recent research (Bannister and Balkin, 1990) has reported that appraisee seems to have greater acceptance of the appraisal process and feel more satisfied with it, when the process is directly linked to rewards.
- Performance measures quantitatively tell us something important about our product services and the processes that produce them. They are the tool to help us understand to manage and improve what our organization's do.
- Performance measures are always tied to goal or an objective (the target) and tell us if and where improvements are necessary.
- Performance appraisal can also be used for transfer and promotions of employees.
- It facilitates human resource planning, career planning and succession planning. It is used to analyze the training and development needs and evaluating the effectiveness of existing training program.
- Performance appraisal provides the management an objective basis for discussing salary increases and special increments of the staff.
- The result of performance appraisal may be used by the supervisor in constructively guiding the employees in the efficient performance of their jobs.

EFFECT OF COMPENSATION ON PERFORMANCE AND MOTIVATION

The design and implementation of a performance measurement and compensation system can strongly effect the motivation of employees. There exists a significant positive relationship between the perceived characteristics of the compensation system and extrinsic motivation. Intrinsic motivation is not affected by the design of the monetary compensation system, but is affected by promotion opportunities. The compensation system also significantly affects other indicators of motivation, namely work satisfaction and turnover intent.

A conceptual model, particularly a derivative of a model by Lawler (1986), includes the interrelationships between employee effort, employee performance, the firm's compensation system, and the motivational level of individuals.

The performance measure is used to evaluate the performance of the employee, which forms the basis for determining the amount of variable monetary compensation an employee will receive and for making career decisions. Fixed compensation, as opposed to variable compensation, does not induce effort and its role is limited to retention and selection. In practice, completely fixed compensation that is totally unrelated to performance is extremely rare, for instance, the probability of being fired creates an incentive to perform.

The combination of elements of the compensation system, i.e. performance measurement and evaluation, monetary compensation and career concerns link employee performance to motivation, which in turn affects effort and other indicators for the level of motivation.

The Lawler Porter model gives following guidelines to motivate their employees:

- Place the right person on the right job and match the abilities and trait of individuals to the requirement of the job.
- Carefully explain to employees what their roles are,and make sure that they understand their roles.
- Prescribe in concrete terms the actual performance levels expected of the individuals.
- Make sure that the employees value the reward dispersed.

There are certain conditions, which are necessary for employee motivation.

1. Employees must believe effective performance (or certain specified behaviour) will lead to certain rewards. For example, attaining certain results will lead to a bonus or approval from others.
2. Employees must feel that the rewards offered are attractive. Some employees may desire promotions because they seek power, but others may want a fringe benefit, such as a pension, because they are older and want retirement security.
3. Employees must believe a certain level of individual effort will lead to achieving the corporation's standards of performance.

It is found that motivation to exert effort is triggered by the prospect of desired rewards: money, recognition, promotion, and so forth. If effort leads to performance and performance leads to desired rewards, the employee is satisfied and motivated to perform again.

The ability of a reward system both to motivate and to satisfy depends on who influences and/or controls the system's design and implementation. Even though, considerable evidence suggests that participation in decision making can lead to greater acceptance of decisions, participation in the design and administration of reward systems is rare. Such participation is time-consuming.

Therefore, it can be seen as an important managerial tool, for an increase in the level of motivation is not limited to an increase in effort. A well perceived compensation system also has a beneficial effect for companies on major indicators of motivation: work satisfaction and turnover intent. We can conclude that a compensation system can be of great importance for managers in order to increase both motivation and individual performance.

PAY FOR PERFORMANCE SYSTEM

The term "Pay for Performance" refers to a pay strategy where evaluations of individual and for organizational performance have significant influence on the amount of pay increases or bonuses given to each employee. If employees see that pay is not distributed on the basis of merit, they are more likely to lack commitment to the organization, which decreases their level of satisfaction. Pay for performance system is also known as incentive system where outstanding performers will receive the greatest rewards, to acknowledge their superior contributions and to motivate them to continue high performance. Average performers will receive substantially smaller raises, which may encourage them to work harder to achieve larger raises in the future.

Pay for performance is a pay strategy which emphasises on the performance evaluation processes that produces the most significant gains. It involves initial clarifying of organizational goals and translating them into individual expectations, thus, emphasis on ongoing communication and progress checks. and the careful assessment of individual accomplishments, which are used to justify the variation in rewards in improving organizational performance.

Objectives of Pay for Performance System

- The main aim is to improve the organization's ability to attract and retain high performers.
- It helps in improving individual efforts and consequently, organizational performance.
- It is a fair way of pay since those who contribute more to the organization receives a large salary in return.
- It helps in inducing a performance-oriented culture and contributes to business objective.
- It helps in linking overall compensation strategy with the organization's business strategy.
- It is an effective motivational technique and improves productivity.
- It helps in upgrading skills of team members by increasing a competitive environment.

Though the system of pay for performance is very effective in increasing performance and motivation, yet it is complex processes that demand a large investment from those who seek to use it. The effectiveness of Pay for Performance System can be undermined by flaws in the design, implementation and operational phases. Above all the performance evaluation system must be accurate and supervisors must be well-versed in its use. Checks and balances should be built in to help supervisors accountable for their decisions. It is also associated with conflict and competition and many times discourages co-operation if not properly evaluated. A competency based pay structure requires practices to commit to ongoing staff training and can entail higher costs. Once implemented, pay for performance system creates a psychological contract i.e., a set of expectations based on past experience, and is very resistant to change between the employee and the firm. In many cases, pay for performance leads to job dissatisfaction and stress. Therefore, to avoid these unfavourable consequences, it is important to have a well-designed pay for performance system.

MEETING THE CHALLENGES OF PAY FOR PERFORMANCE SYSTEM

(a) Competency Based Pay Model

It should be developed to motivate staff and to accomplish the objectives. The main focus of this model should be on the person or individual rather than paying for the job. It includes following features:

(i) Thorough job analysis should be done followed by job description. Conducting a job analysis means identifying the critical behaviours, knowledge, skills, abilities and other personal characteristics that will establish a clear link between job's content, a person's qualifications and optimal performance of that job. A systematic job analysis not only is the basis of your pay system, it's the cornerstone of effective staff management because it gives us accurate information on which effective staff selection, training and performance review system is built.

(ii) Based on the job analysis, identify the competencies needed to perform the job.

(iii) Develop assessments to measure staff member's performance of these competencies.

(iv) Price the competencies by analyzing compensation using data. An investigation is done to analyse staff salaries of local or regional data sources.

(v) Establish a salary for each staff member based on the competencies an individual uses to perform his task.

(b) Development of Practice – Effectiveness Pay Model:

It is one of the methods to combine fixed and variable compensation. It involves setting base salaries plus establishing a method that will provide bonus payment based on certain performance criteria. It offers' certain advantages:

(i) This model helps to control operating costs. A portion of each staff members' salary is tied to the practice performance. In addition, the model itself has low overhead, in that, much of the administrative work related to it involves data collection that should already be taking place as a part of sound management practice.

(ii) It rewards the right behaviours that build unity. Staff members are reinforced only for actions that clearly benefit the practice performance, which focus everyone on the most important work and promote a culture of "we are all in this together". It builds an environment of change and adaptability and is compatible with TQM (Total Quality Management) and CQI (Continuous Quality Improvement).

(iii) It encourages self-management and helps in increased understanding of a practice business interest, which improves staff members' motivation to perform. It also encourages employees to co-ordinate their work with others more effectively and to make decisions that reflect the best interests of the practice.

(iv) It encourages innovation and improves operational efficiency producing tangible rewards for staff.

(c) Developing Employee Trust Relationship

A well designed pay for performance system is effective only if there is a relationship of mutual trust and confidence between the employer and employee. This relationship if implemented successfully helps in making major changes in the organization climate. An employer should care about employee's needs and be aware of the work they do. Also they need to keep employees informed and involved while making any changes in the management or compensation plan.

(d) Enhancement of Employees' Participation

An old saying among Compensation Practitioner is, "Acceptability is the ultimate determinant of success in any compensation plan"(Mejia & Cardy p. 365). Employees should be consulted in the formation of plan to increase their motivation. Employee's involvement is also done sometimes in the areas to design the reward strategies, through attitude survey prior to the consideration of a new reward strategy. Employee involvement will result in a greater understanding of the rationale behind the plan and a better matching between individual needs and pay- plan design.

(e) Use of Performance Linked Incentives

It is important for all participating companies to make use of bonus/profit sharing schemes in their compensation system. Also the use of performance bonuses to motivate executive staff whose salaries are close to or at the maximum of their salary range is done. Instead of using the traditional performance appraisal system, which involves a high degree of subjectivity, companies are adopting performance management system. Employees are assessed on their ability to meet "key results" (i.e., quantifiable targets/objectives).

Some Other's are:

(i) An already well functioning performance management system.

(ii) Strong collaboration with unions.

(iii) Involvement of staff in the reform.

(iv) Clear communication of the objectives and functioning of the performance related pay scheme to staff.

(v) Linkage between individual and organizational objectives.

(vi) Measurement of performance against specific goals or with quantitative measures of performance.

(vii) Clear feedback to staff on the allocation of rating and rewards.

The PRP policy needs to be seen as fair and equitable by all employees.

(i) Organization should provide clear guidance's to participants in PRP scheme on the standards, which are to be used to discriminate between levels of awards and its distribution.

(ii) High level and well differentiated reward.

(iii) Possibility of internal and external review.

(iv) Combination of pay with other incentives such as promotions.

Advantages of Performance Related Pay Scheme

(a) The main rationale for establishing performance related pay policies is to improve performance and motivation of managers or employees. This objective is coupled with the need to provide departments and individual managers with greater flexibility to recognize and reward individual or team performance contributions.

(b) The introduction of PRP at the employee level is also a way to forge a closer link between individual job goals and organizational goals.

(c) This scheme especially at the managerial level helps to attract and retain talent of currently employed worker.

(d) PRP can be used to assist or stimulate organizational change. It might help to achieve cultural change by letting employees know the values and expectations of the organization.

(e) PRP mechanism creates alternative paths, where performance is more important than grade and seniority. This has an important impact on strategic human resources management and constitutes strong incentive for improving staff development and training.

(f) The real motivation to use PRP is to be an instrument to obtain political support for more funding or flexibility over pay. It may also be seen as a way to have better control of the pay bill. It can indeed be a way to contain salary costs by reducing the incidence of automatic progression through salary levels.

(g) The individualization of pay may sometimes also be a way to circumvent collective bargaining process, thus reducing the influence of trade unions' and reestablishing managerial control.

(h) With the introduction of PRP in the organization, opportunities for professional growth are possible for staff, which builds acceptance for change. As staff learns to accept change, the practice becomes better able to react to staff turnover, expansions, mergers or changes in the health care environment.

TYPES OF PAY FOR PERFORMANCE PLANS

There are variety of approaches to reward performance in an organization. The pay for performance plans can be designed to reward the performance of the individual, team, business unit or plant or the entire organization.

There are 3 types of Pay-for-performance Plans on the basis of level of aggregation at which performance is defined.

(a) Individual Based Plans.

(b) Team Based Plans.

(c) Organizational Level Plans.

(a) Individual Based Plans:

The key to individual performance based programs is that they focus specifically on the individual. They are the most widely used pay-for-performance plans in the industry. The assumptions underlying these programs are that an individual can control their own behaviour and given some feedback about the behaviour that is good and that which needs improvement, the employee will choose to improve. Typically, individual performance based system involves one individual, usually a supervisor, evaluating the performance of another individual. If there is enough behaviours that meet their approval, the employee is rewarded. Some of the individual performance plans are:

(i) Merit system.

(ii) Piece rate.

(iii) Executive bonus.

(iv) Individual awards.

(i) Merit System

Merit pay consists of an increase in base pay, normally given once a year. Once a merit pay is given to an employee, it remains a part of that employee' base salary for the rest of his or her tenure within the firm. It is a reward for individual performance based on the performance standards established for their job and is designed to differentiate pay based on differences in work performance. This helps in improving accuracy of performance. However, it was found that merit system is expensive and does not achieve the desired goal of improving employees and corporate performance.

(ii) Piece rate

The straight piece work system is where rate wages vary directly as a function of the production level. This system finds difficulty in setting an appropriate standard straight piece rate plan.

Differential Piece Rate

F.W Taylor started this method as a part of the scheme of Scientific Management. The underlying principle of the system is to reward an efficient worker and penalize the inefficient person. The standard time was fixed for completing a task with the help of time and motion study. He set two piece work rates.

- One rate goes into effect when a worker exceeds the published standard for a given time period – this rate is set higher than the regular wage incentive level.
- A second rate is established for production below standard, and this rate is lower than the regular wage. This method offers good incentive to efficient workers but workers' feels insecure, as no minimum wage is guaranteed.

(i) **Executive Bonus. (Lumpsum payments):** It is similar to merit programs but differ in one important respect. Bonuses are given on a one-time basis and do not raise the employees' base pay permanently. It can be larger than merit pay increases because they involve lower risk to the employer as they are not permanent.

- It is increasingly used as a substitute for merit pay.
- It is based on employee or company performance, employee receives an end-of-year bonus that does not increase base pay.
- Since employees must earn this increase each year, it is viewed as less of an entitlement than merit way.
- This approach will cost an employer considerably less over the long run due to lack of compounding.

However, employees typically do not view lumpsum bonuses favourably since base pay does not increase.

(ii) **Individual Awards:** Awards, like bonuses , are one time rewards, but tends to be given in the form of tangible prize, such as a paid vacation, a television set etc.

(iii) **Employees are usually awarded for exceptional performance,** often on special project or for performance that exceeds expectations by a wide margin.

(iv) **According to recent survey,** 74% of companies reported these awards were highly or moderately effective.

Advantages of Individual Incentive Plan

- These plans lead to unexpected and undesired behaviours since employees, being rational, do more of what the incentive system pays for performance that is reward is likely to be repeated or people tend to do those things that are rewarded.
- It helps to make employee's behaviour consistent with the organization goals, which will increase employee's efforts and make their performance goal oriented.
- It helps to reduce job turnover and absenteeism by maintaining equity in the incentive plan. If high performer is not rewarded they may leave the firm or reduce their performance level.

Disadvantages

- The disadvantage of individual based plan is that they focus on a small part of what it takes for a company to be successful.
- It may create competition and destroy co-operation among peers.
- Although all organizations claim to reward individual performance, it is difficult for employees to determine to what extent their companies really do so. They do not believe that pay and performance are linked.
- Individual based plans work against quality programs as individuals rewarded for meeting production goals often sacrifice attention to product quality.
- Supervisors often do not know how to justify particular pay raise recommendations to an employee.

(b) Team Based Plan: (Group incentive Plan):

Team or Group pays Incentive plan: This plan pay incentive to the team based on the team's performance. If a team is to function effectively, firms should provide a reward based on the overall team performance. For this, the work standards are set for each team member and then output of each member is calculated. By doing so, firm's result becomes more effective, efficient and productive. Group members are paid on the basis of these formulas.

- All members receive the pay earned by the highest producer.
- All members receive the pay earned by the lowest producer.
- All members receive pay equal to the average pay earned by the group.

(*Source:* Dessler Gary p. 336)

Advantages of Team based Incentive Plan

- It is easier to develop performance standards for groups than for individuals.
- All the group members may be more inclined to assist others and work collaboratively, of organization rewards on the basis of team's output.
- An environment of mutual trust and confidence develops among group members.
- Team based plan reinforce team planning, problem solving and creativity.
- Team based approach reduces jealousy conflict and encourages sense of co-operation among group members.
- It also facilitates training, since each member has an interest in getting new members trained as fast as possible.
- Sometimes, intergroup competition leads to decline in overall performance.

Disadvantages

- It generates a feeling of dissatisfaction, if individual employee perceives that they contribute more than other employees in the group and are not properly rewarded.
- The payment of workers may not be proportionate to their efforts which may demotivate hard workers.
- Lack of communication is a familiar factor in failure of team based plan.

Some of the Group or Team Based Plan include:

(i) Gainsharing

(ii) Scanlon Plan

(iii) Rucker Plan

(Explain in detail in Chapter 6)

(c) Organization Wide Incentive Plan:

Many employees have incentive plans in which most employees can participate. Two important ways organization measure their performance are in terms of profit and their stock price. In a competitive market place, profits result when an organization is efficiently providing products that customers want at a price they are willing to pay. Stock is the owner's investment in a corporation. Employer's offer stocks to their employees for several reasons such as attraction, retention and motivation. This organization –level incentive can motivate employees to align their activities with the organization's goals.

Advantages

- These plans offer a possible alternative of incentive plan as compared to others already discussed.
- These plans are generally based on firm's productivity, cost savings or profitability.
- Organization-wide plan motivate employees to align their activities with the organization's goals.
- Increase employee commitment when they are entitled to profitsharing and ESOP's.

Disadvantages

- This plan is involved with high degree of risk and uncertainty, as incentive is linked to organization's profits or stock price.
- There are maximum chances of falling of stock price and profits, as compared to its hike.
- These plans are only effective in organizations that emphasize growth and innovation which tends to need employees who strive in risk-taking environment.
- Organization-wide plan include profit sharing and employee stock ownership plan (ESOP).
- Initially intended to focus attention on costs.
- Formula is tied to group or department performance measures.
- Based upon factors controllable by the group.
- Typically target a specific problem area.
- Direct employee attention to the area or issue.
- Timings are generally monthly or quarterly payouts.
- Reinforces the Performance-reward link.

Types of variable pay plans: Advantages and Disadvantages

Plan Type	What is it?	Advantage	Disadvantages	Why?
Cash profit Sharing	• Award based on organizational profitability • Shares a percentage of profits(typically above a target level of profitability) • Usually annual payout • Can be cash or deferred 401(k)	• Simple, easily understood Low administrative costs	• Profit Influenced by many factors beyond employee control • May be viewed as an entitlement • Limited motivational impact	• To educate employees about business operations • To faster teamwork or "one-for-all" environment
Stock Ownership or Options	• Award of stock shares or options	• Option awards have minimal impact on the financial statements of the company at the time they are granted • If properly communicated, can have powerful impact on employee behaviour • Tax deferral to employee	• Indirect pay / Performance link • Many factors outside individuals influence affect stock price • Employees may be required to put up money to exercise grants	• To recruit top quality employees when organization has highly uncertain futures (i.e., start -ups, high-tech, or biotech industries) • To address employee retention concerns
Balanced Scorecard	• Awards that combine financial and operating measures for organization, business unit and/or individual performance • Award pool based on achieving performance targets • Multiple performance measures may include 1. Non-financial/Operating quality improvements productivity gains, customer service improvements 2. Financial EPS, ROE, ROA, revenues	• Communicates organisational priorities	• Performance criteria may be met, but if financial targets are not met, there may be a reduced payout or no payout at all • Can be complex	• To focus employees on need to increase shareholder value • To focus employees on organization, division, and/or individual goals • To link payouts to a Specific financial and/or operational target
Productivity/ gain sharing	• Awards that share economic benefits of improved productivity quality, or other measurable results • Focus on group, plant, department, or division results • Designed to capitalize on untapped knowledge of employees	• Clear performance reward links • Productivity and quality improvements • Employees knowledge of business increases • Faster teamwork, co-operation	• Can be administratively complicated • Unintended effects, like drop off in quality • Management must "open the books" • Payouts can occur even if companys financial performance is poor	• To support a major productivity quality initiative (such as TQM or reengineering) • To faster teamwork environment • To reward employees for improvements in activities that they control
Team/group incentives	• Awards determined based on team/group performance goals or objectives • Payout can be more frequent than annual and can also extend beyond the life of the team • Payout may be uniform for team/group members	• Reinforces teamwork and team identify results • Effective in stimulating ideas and problem solving • Minimizes distinctions between team members • May better reflect how work is performed	• May be difficult to isolate impact of team • Not all employees can be placed on a team • Can be administratively complex • May create team competition • Difficult to set equitable targets for all teams	• To demonstrate an organizational commitment to teams • To reinforce the need for employees to work together to achieve results

Source: Kenam S. Abosch,"Variable Pay: Do We Have the Basics in Place?" *Compensation and Benefits Review*, 30(4) 1998, pp. 12-22

Fig. 4.2

DOES COMPENSATION MOTIVATE PERFORMANCE

Psychologist Herzberg says that money only buys temporary compliance, and that as soon as you remove the incentive, the motivation disappears. He said employers' should provide adequate financial rewards and then build other more effective motivators (like opportunities for achievement and psychological success) into jobs.

Motivation and performance are very complex issues affected by many factors.. No one factor can guarantee motivation or performance in the absence of other critical factor. Some people think that money cannot be used to motivate employees and that is true for some employees, but for a large percentage of the workforce it does not have to be that way. The studies shows that, almost everyone is motivated by money to some degree, many to a moderate degree, and most to a great degree when compensation is properly designed. Some psychologist would argue that money does not change behaviour because they do not consider it properly termed a "motivator " but rather they call it a "director" of behaviour. This is a semantic argument. The idea is whether money can be used as a tool to change employee behaviour in a desirable direction. Inadequate use of incentive plans and problems with compensation design and strategy often fails to motivate performance of an employee.

Behavioural scientist, employee and management survey experiences show that compensation can be a strong driver of employee behaviour under the right circumstances when properly designed. Also in jobs where significant variability in pay occurs in compensation and where it is closely related to key performance factor, then pay can be a big motivator.

The good performers prior to new compensation plan implementation remain good performers and may not improve much because they are already giving close to 100% effort, but the middle and the bottom performers are where there is significant opportunity for change. It has been found that failure in poor compensation design leads to failure to motivate. Typical compensation design problems include–

(i) Failure to tie pay closely to achievement of objective and realistic performance measures.

(ii) Failure to regularly measure and provide feedback on performance.

(iii) Failure to design variances in pay related to performance that is large enough to be perceived by the employee as worth the effort.

Thus, it is found that compensation motivates performance but one of the single impediments to the use of compensation as motivator is the managers' inability to measure employee performance accurately and regularly and failure to set goals or standards that are challenging, realistic and have strong relationship to business success.

KEY TERMS

Pay-for-performance	Organisation-wide plan
Individual based plan	Piece-rate
Team based plan	