COMPENSATION MANAGEMENT

CHAPTER 7 (Study unit 6)
Defining Competitiveness

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Chapter Topics

- Compensation Strategy: External Competitiveness
- What Shapes External Competitiveness?
- Labor Market Factors
- Modifications to the Demand Side
- Modifications to the Supply Side
- Product Market Factors and Ability to Pay

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Learning objectives

After studying Chapter 7, students should be able to:

- Explain the importance of external competitiveness to the pay model.
- Discuss the factors that influence external competitiveness.
- Discuss the differences among labor market, product market, and organizational factors in determining external competitiveness.
- Explain the different pay policy positions and the consequences of using each.

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Chapter Topics (cont.)

- Organization Factors
- Relevant Markets
- Competitive Pay Policy Alternatives
- Consequences of Pay-Level and Mix Decisions: Guidance from the Research
- Your Turn: Sled Dog Software
- Still Your Turn: Fit the Pay Mix Policy to the Compensation Strategy

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Compensation Strategy: External Competitiveness

- External competitiveness is expressed in practice by:
  - Setting a pay level that is above, below, or equal to that of competitors
  - Determining mix of pay forms relative to those of competitors
- Pay level and pay mix decisions focus on:
  - Controlling costs
  - Attracting and retaining employees

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What Is External Competitiveness?

External competitiveness **refers to pay relationships among organizations - an organization's pay relative to its competitors.**

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What is Pay Level?

Pay level **refers to the average of the array of rates paid by an employer: (base + bonuses + benefits + value of stocks) / number of employees.**

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What are Pay Forms?

Pay forms **are the various types of payments, or pay mix, that make up total compensation.**

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Pay Level and Pay Mix: Two Objectives

Control Costs

Attract and Retain Employees

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Pay Level Decisions Impact Labor Cost

Labor Costs = **Pay Level** x **Number of Employees**

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Exhibit 7.1: Single Company's Market Position May Differ Depending on Whether Comparing Base Pay or Total Compensation

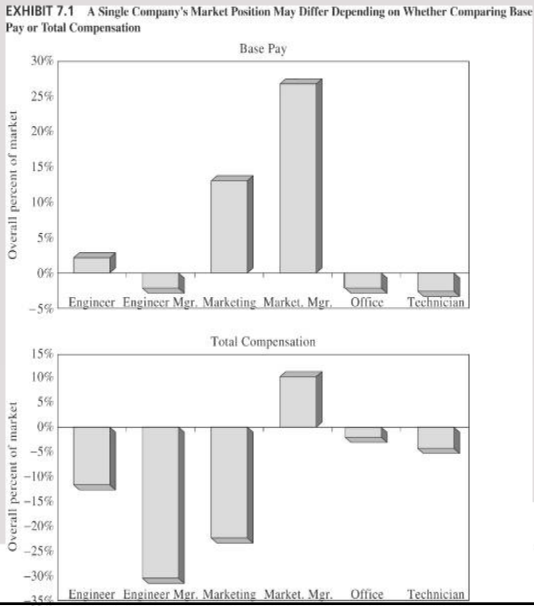

Exhibit 7.2: Two Companies: Same Total Compensation, Different Mixes

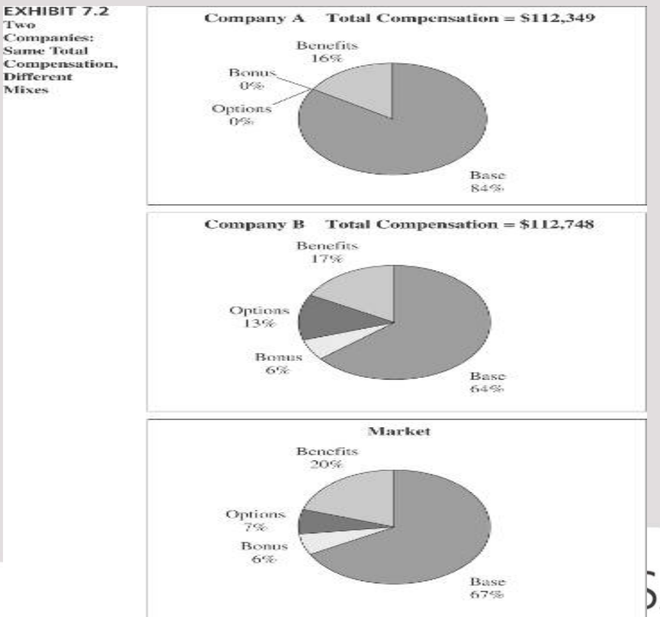

Exhibit 7.3: What Shapes External Competitiveness?

LABOR MARKET FACTORS
Nature of Demand
Nature of Supply

PRODUCT MARKET FACTORS
Degree of Competition
Level of Product Demand

ORGANIZATION FACTORS
Industry, Strategy, Size
Individual Manager

EXTERNAL COMPETITIVENESS

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How *Labor Markets* Work

- Theories of labor markets begin with four assumptions
  - Employers always seek to maximize profits
  - People are homogeneous and therefore interchangeable
  - Pay rates reflect all costs associated with employment
  - Markets faced by employers are competitive
- Understanding how the market works requires an analysis of the demand and supply of labor
- Demand: focuses on the actions of the employers: How many new hires they seek and what they are willing and able to pay new employees
- Supply: looks at potential employees – their qualifications and the pay they are willing to accept in exchange for their services

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Labor Demand

- Analysis of *labor demand* indicates how many employees will be hired by an employer
- In the short run, an employer cannot change any factor of production except human resources
  - An employer's level of production can change only if it changes the level of human resources
  - An employer's demand labor coincides with the marginal product of labor

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Labor Demand (cont.)

- ***Marginal product of labor***
  - Additional output associated with employment of one additional human resources unit, with other production factors held constant
- ***Marginal revenue of labor***
  - Additional revenue generated when firm employs one additional unit of human resources, with other production factors held constant
  - A manager using the marginal revenue product model must:
    - Determine pay level set by market forces
    - Determine marginal revenue generated by each new hire

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Exhibit 7.4: Supply and Demand for Business School Graduates in the Short Run

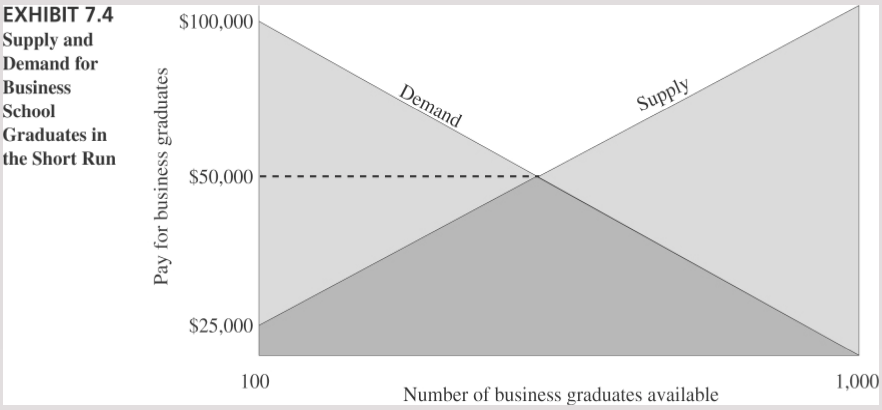

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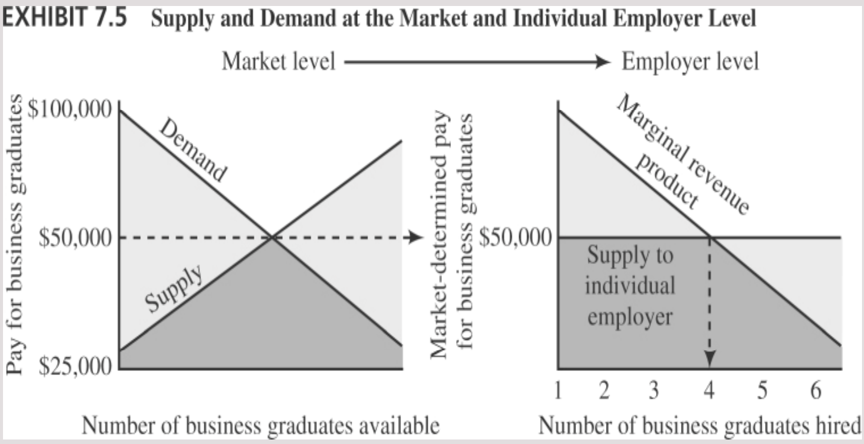
Exhibit 7.5: Supply and Demand at the Market and Individual Employer Level



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Labor Supply

- Assumptions on behavior of potential employees
  - Several job seekers
  - Possess accurate information about all job openings
  - No barriers exist to mobility among jobs
- Upward sloping supply curve:
  - More people willing to take a job as pay increases
- If unemployment rates are low, offers of higher pay may not increase supply = everyone who wants to work is already working. If competitors quickly match a higher offer, the employer may face a higher pay level but no increase in supply

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Modifications to the Demand Side

- Economic theories must frequently be revised to account for reality
  - When focus changes from *all* the employers in an economy to a *particular* employer, models must be modified to help understand what actually occurs
- Issue for economists:
  - Why would an employer pay more than what theory states is the market-determined rate?

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Exhibit 7.6: Labor Demand Theories and Implications

EXHIBIT 7.6
Labor Demand Theories and Implications

Theory	Prediction	So What?
Compensating differentials	Work with negative characteristics requires higher pay to attract workers.	Job evaluation and compensable factors must capture these negative characteristics.
Efficiency wage	Above-market wages will improve efficiency by attracting workers who will perform better and be less willing to leave.	Staffing programs must have the capability of selecting the best employees; work must be structured to take advantage of employees' greater efforts.
Signaling	Pay policies signal the kinds of behavior the employer seeks.	Pay practices must recognize desired behaviors with more pay, larger bonuses, and other forms of compensation.

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Compensating Differentials

- According to Adam Smith, "If a job has negative characteristics then employers must offer higher wages to compensate for these negative features"
- For instance, if:
  - Necessary training is very expensive
  - Job security is tenuous
  - Working conditions are disagreeable
  - Chances of success are low

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Efficiency Wage

- According to efficiency-wage theory, high wages may increase efficiency and actually lower labor costs if they:
  - Attract higher-quality applicants
  - Lower turnover
  - Increase worker effort
  - Reduce “shirking”
  - Reduce the need to supervise employees
- Efficiency increases by hiring better employees or motivating present employees to work smarter and harder
- Underlying assumption = pay level determines effort

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Efficiency Wage (cont.)

- Research evidence states:
  - Higher wages associated with lower shirking (measured as number of disciplinary layoffs)
    - Inconclusive evidence on if it was cut enough to offset higher wage bill
  - Higher wages do attract more qualified applicants
    - Also attract more unqualified applicants
- Above-market wage allows organizations to operate with fewer supervisors

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Signaling

- Employers deliberately design pay levels and mix as part of a strategy that signals to both prospective and current employees kinds of behaviors sought
  - Policy of paying below the market for base pay yet offering generous bonuses or training opportunities
- On the supply side of the model:
  - Suppliers of labor signal to potential employers
  - Characteristics of applicants, and organization decisions about pay level and mix act as signals that help communicate

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Exhibit 7.7: Supply Side Theories and Implications

EXHIBIT 7.7
Supply Side Theories and Implications

Theory	Prediction	So What?
Reservation wage	Job seekers will not accept jobs whose pay is below a certain wage, no matter how attractive other job aspects.	Pay level will affect ability to recruit.
Human capital	The value of an individual's skills and abilities is a function of the time and expense required to acquire them.	Higher pay is required to induce people to train for more difficult jobs.

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Product Market Factors and Ability to Pay

- Two key product market factors affect ability of a firm to change price of its products or services
  - *Product Demand* – Puts a lid on maximum pay level an employer can set. If the employer pays above the maximum, it must either pass on to consumers the higher pay level through price increases or hold prices fixed and allocate a greater share of total revenues to cover labour costs
  - *Degree of competition* – In highly competitive markets, employers are less able to raise prices without loss of revenue**s**
- Dose of reality: What managers say
  - Provides insight into how all the economic factors translate into actual pay decisions

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More Reality: Segmented Supplies of Labor

- **People flow to the work**
  - Some firms (Example: St. Luke's Hospital) face a *segmented labor supply* that involves
    - Multiple sources of employees
    - From multiple locations
    - With multiple employment relationships
  - This implies a company uses multiple sources of employees, from multiple locations, with multiple employment relationships
  - The level and mix of cash and benefits paid to each employee depends on the source
  - The segmented supply results in employees working the same jobs side by side but earning significantly different pay

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Segmented Supplies of Labor (cont.)

- Work flows to the people
  - On-site
  - Off-site
  - Offshore

Conclusions from Discussion

- Reality is complex; theory abstracts
- Segmented sources of labor means that determining pay levels and mix requires understanding market conditions in different locations
- Managers need to know:
  - Jobs required to do the work
  - Tasks to be performed
  - Knowledge and behaviors required to perform them

Organization Factors

- ***Industry and Technology*** in which an organisation competes influences the technologies used. Labour-intensive industries tend to pay lower than technology-intensive industries
- ***Employer siz***e: large organizations tend to pay more than smaller organizations. This is consistent with the economic theory
- ***People's preferences:*** organizations need to establish what pay forms (health insurance, bonuses, pensions, etc.) employees value
- ***Organization strategy:*** Different organizations have different pay strategies depending on their circumstances

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Relevant Markets

- Managers needs to determine the relevant labour markets that are relevant for pay purposes and establish appropriate competitive positions in these markets
- Three factors determine relevant labor markets
  - Occupation: skills/knowledge required
  - Geography: willingness to relocate, commute or become virtual employees
  - Competitors: other employers in the same product/service and labour markets

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Relevant Markets (cont.)

- Employers choose their relevant markets based on
  - Competitors – Products, location, and size
  - Jobs – Skills and knowledge required and their importance to organizational success
- Data from product market competitors likely to receive greater weight when:
  - Employee skills are specific to the product market
  - Labor costs are a large share of total costs
  - Product demand is responsive to price changes
  - Supply of labor is not responsive to changes in pay

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Competitive Pay Policy Alternatives

- Three conventional pay-level policies:
  - To lead
  - To meet
  - To follow competition
- Newer policies emphasize flexibility among:
  - Policies for different employee groups
  - Pay forms for individual employees
  - Elements of the employee relationship that company wishes to emphasize in its external competitiveness policy

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Competitive Pay Policy Alternatives

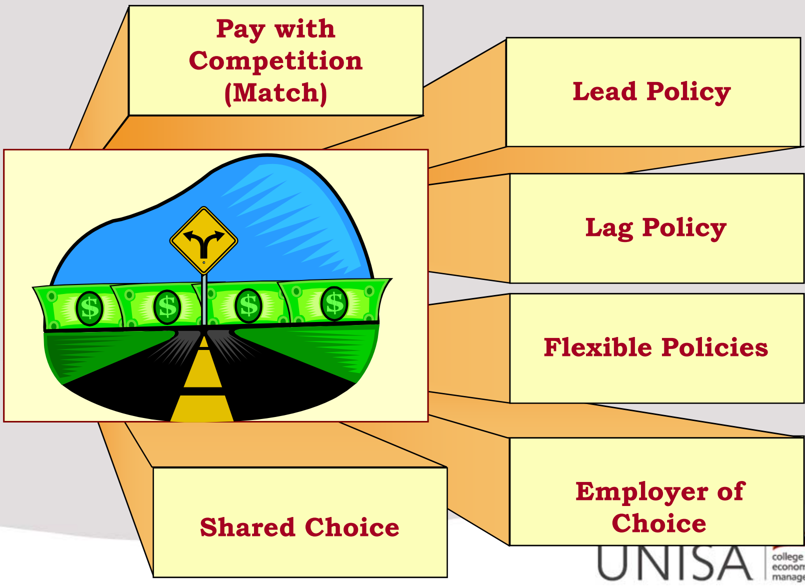

Exhibit 7.8: Probable Relationships Between External Pay Policies and Objectives

EXHIBIT 7.8 Probable Relationships between External Pay Policies and Objectives

	Compensation Objectives				
Policy	Ability to Attract	Ability to Retain	Contain Labor Costs	Reduce Pay Dissatisfaction	Increase Productivity
Pay above market (lead)	+	+	?	+	?
Pay with market (match)	=	=	=	=	?
Pay below market (lag)	−	?	+	−	?
Hybrid policy	?	?	+	?	+
Employer of choice	+	+	+	−	?

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Pay with Competition (Match)

- Attempts to ensure an organization's
  - Wage costs are approximately equal to those of its product competitors
  - Ability to attract potential employees will be approximately equal to its labor market competitors
- Avoids placing an employer at a disadvantage in pricing products or in maintaining a qualified work force

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Lead Policy

- Maximizes the ability to attract and retain quality employees and minimizes employee dissatisfaction with pay
- May also offset less attractive features of work
- If used only to hire new employees, may lead to dissatisfaction of current employees
- May mask negative job attributes that contribute to high turnover later (e.g. boring assignments or hostile colleagues)

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Lag Policy

- A policy of paying below-market rates
- May hinder a firm's ability to attract potential employees
- If pay level is lagged in return for promise of higher future returns
  - May increase employee commitment
  - Foster teamwork
  - May possibly increase productivity

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Flexible Policies

- Employers have more than one pay policy
- Policy may vary for different occupational families
- Alternative policies include
  - Performance driven
  - Market match: mimicking the pay mix competitors are paying
  - Work/life balance
  - Security

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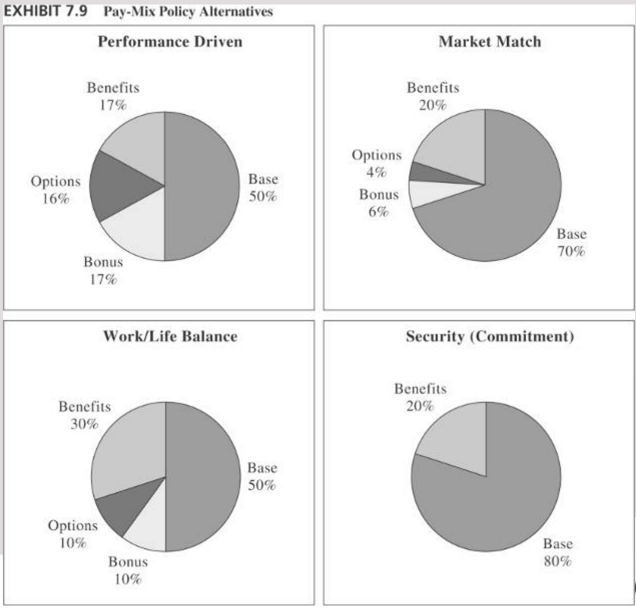
Exhibit 7.9: Pay-Mix Policy Alternatives



Employer of Choice/ Shared Choice

- Companies compete based on their overall reputation as a place to work
- *Shared choice* begins with traditional options of lead, meet, or lag
  - Adds a second part – *offers employees choices* (within limits) in the pay mix
- Similar to employer of choice in recognizing importance of both pay level and mix
- Employees have more say in forms of pay received

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Exhibit 7.12: Pay Mix Varies Within the Structure

EXHIBIT 7.12
Merrill Lynch's Pay Mix Varies within the Structure

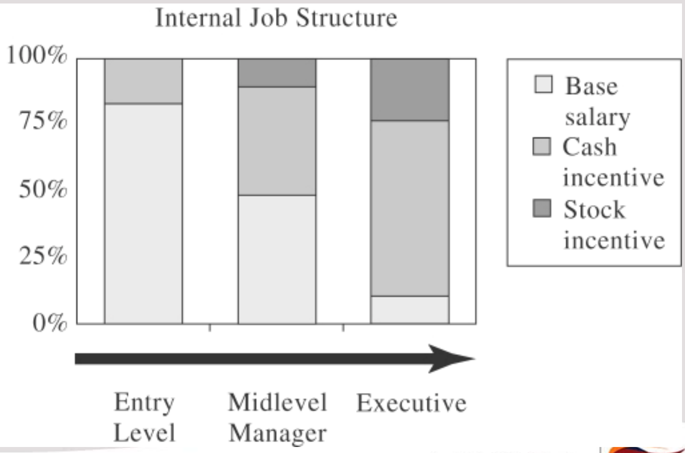

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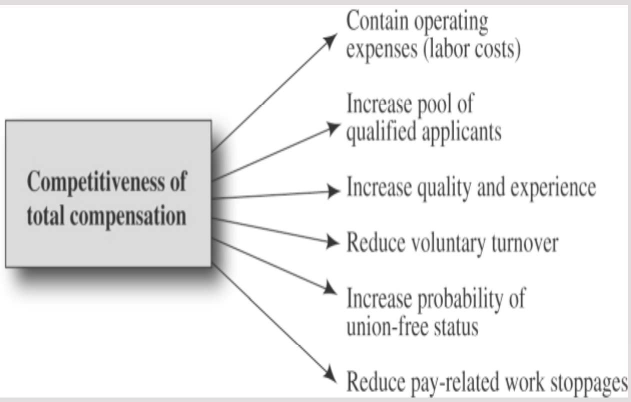
Exhibit 7.13: Some Consequences of Pay Levels

EXHIBIT 7.13
Some Consequences of Pay Levels



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Consequences of Pay-Level and Mix Decisions

- Efficiency
- Fairness
- Compliance

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Which Pay Policy Achieves Competitive Advantage?

- Involves assessing consequences of different pay policy options
- Evidence:
  - Pay level affects costs
  - Effects on productivity
  - Effects on ability to attract and retain employees
- Possibility of achieving competitive advantage
  - Message that pay level and mix signal to people

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Your turn

Answer the end of chapter 7 review questions

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