Strategic Compensation

A Human Resource Management Approach

Joseph J. Martocchio

NINTH EDITION

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Preface

The measure of a company's success is as much a function of the way it manages its employees as it is a function of its structures and financial resources. Compensating employees represents a critical human resource management practice: Without strategic compensation systems, companies cannot attract and retain the best-qualified employees. Spending more than is necessary to attract and retain top talent adds costs unnecessarily to companies in search of competitive advantage.

The purpose of this book is to provide knowledge of the art and science of compensation practice and its role in promoting companies' competitive advantage. Students will be best prepared to assume the roles of competent compensation professionals if they possess a grounded understanding of compensation practices and the environments in which business professionals plan, implement, and evaluate compensation systems. Thus, we examine the context of compensation practice, the criteria used to compensate employees, compensation system design issues, employee benefits, challenges of compensating key strategic employee groups, pay and benefits around the world, and challenges facing compensation professionals.

New to the Ninth Edition

1. *Crunch the Numbers!* are data driven exercises written to provide students with an opportunity to analyze data about one or more compensation issue contained within the respective chapters. One of the key skills a successful compensation professional should have is quantitative analysis for making informed compensation decisions. There are two exercises per chapter, which are assignable. The first exercise is contained at the end of each chapter and in MyManagementLab. An additional exercise appears in MyManagementLab only. Answers are found in the Instructors Manual and in the instructor's section of MyManagementLab.
2. Dozens of new company examples, including Apple Computer, Boeing, Uber, and Wyeth Pharmaceuticals, appear throughout the book, bringing discussions of compensation practices to life.
3. The ninth edition includes 39 additional concepts and practices to maintain the book's position on leading edge knowledge and practice. Some of these concepts and practices include definitive proxy statements, point factor leveling, and the newly approved CEO pay-ratio rule. More than 150 new endnotes document the substantially updated material. For example, Chapter 15 includes a discussion of a possible increase to the federal minimum wage rate and its potential impact on a company's practice.
4. Each chapter contains a feature titled *Watch It* which highlights a short video of a company's experience with particular elements of compensation or HR-related issues, and it is integrated within the chapter material. The video and accompanying questions are available in MyManagementLab.
5. The ninth edition has 15 chapters, which is one fewer than in the eighth edition. Specifically, Chapter 10 in the eighth edition on retirement plans and health care plans has been revised and streamlined, and the material redistributed to Chapter 9 (Discretionary Benefits) and Chapter 10 (Legally Required Benefits). In the ninth edition, employer-sponsored retirement plans appear in Chapter 9 and employer-sponsored health care appears in Chapter 10, to properly represent this practice as a legally required benefit under the *Patient Protection and Affordable Care Act of 2010*.
6. An expanded chapter summary is organized by learning objectives.

MyManagementLab Suggested Activities

For the ninth edition, the author is excited that Pearson's MyManagementLab has been integrated fully into the text. These new features are outlined below. Making assessment activities available online for students to complete before coming to class will allow you the professor more discussion time during the class to review areas that students are having difficulty in comprehending.

Chapter Warm-Up

Students can be assigned the Chapter Warm-Up before coming to class. Assigning these questions ahead of time will ensure that students are coming to class prepared.

Watch It

This feature recommends a video clip that can be assigned to students for outside classroom viewing or that can be watched in the classroom. The video corresponds to the chapter material and is accompanied by multiple choice questions that re-enforce student's comprehension of the chapter content.

Crunch The Numbers

There are two data-driven exercises per chapter, one in the book and both in MyManagementLab. Answers are found in the Instructors Manual and in MyManagementLab.

Assisted-Graded Writing Questions

These are short essay questions that the students can complete as an assignment and submit to you, the professor, for grading.

About This Book

This book contains 15 chapters, lending itself well to courses offered as 8-week modules, 10-week quarters or, 15-week semesters. The chapters are organized in six parts and an epilogue (contained in Chapter 15):

- Part I: Setting the Stage for Strategic Compensation
- Part II: Bases for Pay
- Part III: Designing Compensation Systems
- Part IV: Employee Benefits
- Part V: Contemporary Strategic Compensation Challenges
- Part VI: Compensation Issues Around the World
- Epilogue: Challenges Facing Compensation Professionals

Course instructors on an 8-week module schedule or a 10-week schedule might consider spending about two weeks on each part. Instructors on a 15-week schedule might consider spending about one week on each chapter.

A practical approach to teaching compensation will focus on the considerations and practices common in the field of compensation. This textbook is well suited to a variety of students, including undergraduate and master's degree students. In addition, this text was prepared for use by all business students, regardless of their majors. Both human resource management majors and other majors (e.g., accounting, finance, general management, international management, marketing, and organizational behavior) will benefit equally well from *Strategic Compensation*. After all, virtually every manager, regardless of functional area, will be involved in making compensation decisions. Both practitioners beginning work in compensation and current professionals will find *Strategic Compensation* a useful reference. Among the features, *Compensation in Action* will clarify the connections between compensation and other functions.

Available Teaching and Learning Aids

The teaching and learning accessories are designed to promote a positive experience for both instructors and students.

A feature titled *Compensation in Action* appears at the end of every chapter in the text. This feature provides clear operational points to illustrate how line managers, employees, and compensation professionals interact to put compensation concepts into practice. The feature was prepared by Mr. Gentz Franz, Director of Development at the University of Illinois.

Short end-of-chapter cases have been included in the text. These cases were written by Professor Lori Long of Baldwin-Wallace College about real-world compensation issues, with questions to facilitate class discussion or to be used as homework assignments. The new *Crunch the Numbers!* feature, as described previously, appears in each chapter following the case as well as in MyManagementLab as assignable exercises. This feature provides students with an opportunity to provide a quantitative analysis of data pertinent to compensation practice.

Building Strategic Compensation Systems Project

This accompanying experiental case available online in MyManagementLab will allow students to work in small compensation consulting teams charged with the responsibility for developing a compensation plan for a company named e-sonic. The project is divided into four sections. The first section, *Strategic Analysis*, is described fully in the casebook for faculty and students who choose to complete this optional analysis of the business environment prior to the remaining three sections that directly address compensation system design, and it relates to Chapter 1 of the textbook.

Section 1: Chapter 6

Section 2: Chapter 7

Section 3: Chapters 2 through 5, 8 through 9

The development of a strategic analysis provides context for all decisions made regarding students' compensation systems throughout the project. The strategic analysis reveals firm-specific challenges, objectives, and initiatives that allow students to align the goals of a compensation system effectively with that of their company strategy.

Section 1 introduces students to the specification of internally consistent job structures. Through writing job descriptions, the development of job structures, and both the development and implementation of a point job evaluation method to quantify job differences objectively, students build the framework for internal equity.

Section 2 shifts students' focus outside of their firm to understand its relationship with the external marketplace. Students will use market survey data to compare pay rates of positions inside the firm with those in the marketplace to establish the foundations of market-competitive pay. The analysis of market data also leads students to the determination of appropriate pay-policy mixes for each of their job structures. In this section, students are asked to use CompAnalysis software developed by Howard Weiss at Temple University, which is also available on MyManagementLab. The software is enabled to work in Apple and PC products.

Finally, in Section 3, students will recognize the contributions of employees through the creation of a merit-pay system and put their plan into action by paying employees within their firm. Hypothetical pay discrepancies are introduced to each student group for resolution within the parameters of their designed compensation system. They are tasked with many of the difficult decisions that compensation professionals face on a daily basis.

The Strategic Analysis section and Sections 1 through 3 may each be completed in two to three weeks, which fits well with semester-long courses. Instructors whose courses include a variety of additional activities or span only 7 to 10 weeks may have students complete only three of the four sections in either configuration (Strategic Analysis and Sections 1 and 2 or Sections 1 through 3). The instructor may have student groups prepare written reports or oral presentations to the class. Report outlines are included in the casebook.

Instructor Resources

At the Instructor Resource Center, www.pearsonhighered.com/irc, instructors can easily register to gain access to a variety of instructor resources available with this text in downloadable format. If assistance is needed, our dedicated technical support team is ready to help with the media supplements that accompany this text. Visit http://247.pearsoned.com for answers to frequently asked questions and toll-free user support phone numbers.

The following supplements are available with this text:

- **Instructor's Resource Manual**
- **Test Bank**
- **TestGen® Computerized Test Bank**
- **PowerPoint Presentation**

Acknowledgments

From Pearson Education, I would like to thank Senior Acquisitions Editor Kris Ellis-Levy, Program Manager Sarah Holle, and Project Manager Meghan DeMaio for their guidance and expertise, as well as for the many other professionals who worked behind the scenes in the design, marketing, and production of this edition. I thank each and every one of those individuals for their contributions.

Joseph J. Martocchio

I

SETTING THE STAGE FOR STRATEGIC COMPENSATION

1 Strategic Compensation

A Component of Human Resource Systems

Learning Objectives

When you finish studying this chapter, you should be able to:

1-1. Define strategic compensation.

1-2. Summarize the role of compensation as a strategic business partner.

1-3. Explain strategic compensation decisions.

1-4. Identify and discuss the building blocks and structural elements of strategic compensation systems.

1-5. Describe the fit of the compensation function in organizations.

1-6. Identify the stakeholders of the compensation function and summarize their stakes in the work compensation professionals perform.

CHAPTER WARM-UP!

If your professor has assigned this, go to the Assignments section of **mymanagementlab.com** to complete the Chapter Warm-Up! and see what you already know. After reading the chapter, you'll have a chance to take the Chapter Quiz! and see what you've learned.

Through the early twentieth century, manpower planning was the predecessor to contemporary human resource (HR) management. Manpower planning focused on the effective deployment of employees in factories to achieve the highest manufacturing output per employee per unit of time. That is, management sought to increase productivity (such as the number of handmade garments per hour) while also maintaining or lowering employee compensation costs. All else equal, higher employee productivity while maintaining or lowering employee compensation costs contributed to higher profitability for the firm.

Through the decades, mounting government regulation involving payroll taxes and laws centered on ensuring a minimum wage, prevailing wage, equal pay for equal work, and equal employment opportunity later gave rise to the personnel management function, of which compensation was a component. Legal compliance necessitated that personnel management take on the role of an administrative, support function to maintain compliance with the myriad details of employment laws (e.g., determining prevailing wages in localities). Personnel management departments also engaged in transactions (e.g., payroll administration) with an eye toward administrative efficiency. Administrative efficiency is essential because it can *indirectly* contribute to company success through cost control.

Since the early 1980s, there has been growing widespread recognition that managing employees or human resources can contribute *more directly* to competitive advantage. **Competitive**

advantage describes a company's success when the company acquires or develops capabilities that facilitate outperforming the competition. For example, Walmart is a successful retailer, in part, because its sheer size enables it to negotiate lower prices with suppliers (e.g., of clothing) than smaller retailers. In turn, Walmart is able to sell products at a price advantage relative to most competitors. Other resources may include the employment of highly skilled employees who can operate and troubleshoot problems with sophisticated robotic equipment, which can increase the pace of production while also maintaining quality.

Designing HR practices with competitive advantage in mind casts HR as a strategic function rather than as one that focuses exclusively on conducting transactions. In a strategic role, HR professionals proactively put forth forward-looking principles and ideas, and they play an important role in contributing to successful business outcomes by attracting, motivating, and retaining highly qualified employees.

DEFINING STRATEGIC COMPENSATION

1-1 Define strategic compensation.

"What is strategic compensation? Answering this question requires that we first answer the question, "What is compensation?"

What is Compensation?

Compensation represents both the intrinsic and extrinsic rewards employees receive for performing their jobs and for their membership as employees. Together, both intrinsic and extrinsic compensation describe a company's total compensation system, which we will look at more closely in this chapter, and, in even greater detail throughout the remainder of this textbook.

Intrinsic compensation reflects employees' psychological mind-sets that result from performing their jobs, for example, experiencing a great feeling from the belief that one's work matters in the lives of others. Perhaps it is easy to imagine that many health care providers feel this way. **Extrinsic compensation** includes both monetary and nonmonetary rewards. Organizational development professionals promote intrinsic compensation through effective job design. Compensation professionals are responsible for extrinsic compensation, which is the focus of this textbook.

Compensation professionals establish monetary compensation programs to reward employees according to their job seniority, performance levels, or for learning job-related knowledge or skills. Some describe this exchange as a pay-effort bargain. As we will discuss shortly, monetary compensation represents **core compensation**. Nonmonetary rewards include protection programs (e.g., medical insurance), paid time off (e.g., vacations), and services (e.g., day care assistance). Most compensation professionals refer to nonmonetary rewards as **employee benefits**. Employees receive some or all of these offerings as part of an employment arrangement. Rarely do employers base employee benefits on job performance. Employee benefits are becoming an increasingly important element of compensation packages. Since the so-called Great Recession (2007–2009) ended, fewer companies have offered pay increases and, those that do, are offering lower amounts (from roughly an average 3.8 percent increase to less than 2 percent).[1]

Both monetary and nonmonetary compensation represents costs to companies. In the case of core compensation, employers pay an hourly wage or salary. In the case of employee benefits, employers pay some or all of the cost for employees to have health insurance coverage rather than providing dedicated monetary payments, apart from wage or salary, to pay for health care.

What Is Strategic Compensation?

Defining strategic compensation requires that we place the relevance and importance of compensation practices in a broader context where compensation practices are linked to competitive business strategy, as shown in Figure 1-1. **Competitive business strategy** refers to the

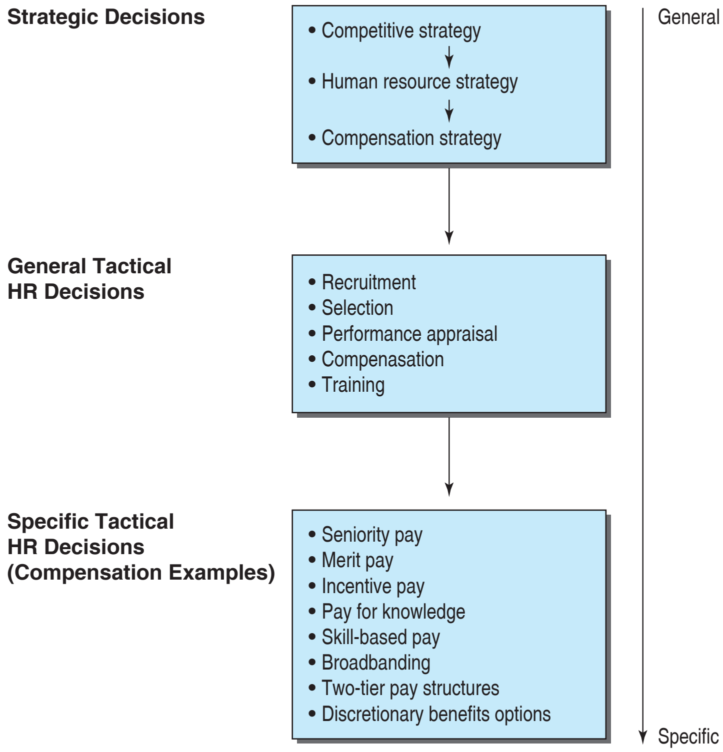

FIGURE 1-1 Relationship between Strategic Decisions and Compensation Practices

planned use of company resources—financial capital, equipment capital, and human capital—to promote and sustain competitive advantage. The time horizon for strategic decisions may span multiple years. For example, Exxon Mobil Corporation, a company in the oil and gas exploration industry, strives to be the world's premier petroleum and petrochemical company by achieving superior financial and operating results while simultaneously adhering to high ethical standards.[2] Eli Lilly and Company, a manufacturer of pharmaceutical products, pursues a competitive strategy, which focuses on creating innovative medicines that improve patient health outcomes.[3]

Human resource executives collaborate with company executives to develop human resource strategies. **Human resource strategies** specify the use of multiple HR practices to reinforce competitive business strategy. These statements are consistent with a company's competitive strategy. For example, Eli Lilly is well known for the innovative environment that it creates for employees to make discoveries for pharmaceutical products that will enhance the life of people throughout the world.[4]

Within the context of competitive business strategy and human resource strategy, compensation professionals practice strategic compensation. **Strategic compensation** refers to the design and implementation of compensation systems to reinforce the objectives of both HR strategies and competitive business strategies. Compensation and benefits executives work with the lead HR executive and the company's chief financial officer (CFO) to prepare total compensation strategies. At Lilly, it is evident that the use of compensation and benefits practices supports both human resource strategies and competitive strategies. Eli Lilly is well known for offering a balanced compensation and benefits program which recognizes employee contributions and embraces employees through recognition of their needs outside the workplace.[5]

COMPENSATION AS A STRATEGIC BUSINESS PARTNER

1-2 Summarize the role of compensation as a strategic business partner.

As noted earlier, personnel administration was transformed from a purely administrative function, engaged in transactions such as payroll processing, to a competitive resource in many companies emerging during the 1980s. Technological advances (e.g., the use of robotics in manufacturing) and global competition (e.g., increased imports of Japanese automobiles) contributed greatly to the need for a strategic approach. As a strategic business partner, HR and compensation professionals today need to think like the chief executive officer (CEO) to become a strategic partner in achieving organizational plans and results.[6] Essentially, they must know more than just HR work.[7] For example, GE's Human Resources Leadership Program (HRLP)[8] is an exemplar of these ideas. The HRLP provides participants with opportunities to learn HR competencies, global leadership skills, and business acumen through formal training and rotational assignments in areas such as compensation, staffing, and employment relations. Participants also receive exposure to GE executives and HR leaders to put their work in the context of strategic issues facing the company. In doing so, they understand the production and service sides of the business and help to determine the strategic capabilities of the company's workforce, both today and in the future. For example, increasing sales and building brand loyalty are important goals of soft drink companies such as Coca Cola and PepsiCo. Increasing sales requires hiring highly dedicated and motivated sales employees whose success is rewarded through innovative sales incentive arrangements.

Compensation professionals can give the CEO and CFO a powerful understanding of the role that employees play in the organization and the way it combines with business processes to expand or shrink shareholder value. Compensation professionals are integrating the goals of compensation with the goals of the organization and focusing on expanding its strategic and high-level corporate participation with an emphasis on adding value.

Perhaps a useful way to better understand *how* HR functions serve as a strategic business partner is to think about the role of capital for value creation. **Capital** refers to the factors that enable companies to generate income, higher company stock prices, economic value, strong positive brand identity, and reputation. There is a variety of capital that companies use to create value, including financial capital (cash) and capital equipment (state-of-the-art robotics used in manufacturing). Employees represent a specific type of capital called human capital. **Human capital**, as defined by economists, refers to sets of collective skills, knowledge, and abilities that employees can apply to create value for their employers. Companies purchase the use of human capital by paying employees an hourly wage or salary and providing benefits such as paid vacation and health insurance.

Compensation professionals can help leverage the value of human capital in a variety of ways. For example, well-designed merit pay programs reinforce excellent performance by awarding pay raises commensurate with performance attainments. The use of incentive pay practices is instrumental in changing the prevalent entitlement mentality U.S. workers have toward pay and in containing compensation costs by awarding one-time increases to base pay once work objectives have been attained. Pay-for-knowledge and skill-based pay programs are key to giving employees the necessary knowledge and skills to use new workplace technology effectively. Management can use discretionary benefit offerings to promote particular employee behaviors that have strategic value. For example, employees who take advantage of tuition reimbursement programs gain knowledge and skills that directly add value to the work they do. In line with these ideas, Bosch offers a unique program to individuals who are pursuing PhD degrees at well-respected universities.[9] The company hires doctoral candidates on a limited-term basis while these students undertake dissertation work under the auspices of Bosch scientists who are working on pressing company matters of scientific importance. This arrangement is a win–win situation because students have direct access to research facilities and Bosch benefits from individuals who are gaining state-of-the-art knowledge and skills in their doctoral programs.

STRATEGIC COMPENSATION DECISIONS

1-3 Explain strategic compensation decisions.

Compensation professionals provide a strategic contribution to the company when they can answer *yes* to the following three questions:

- Does compensation strategy fit well with the objectives of competitive business and HR strategies?
- Does the choice and design of compensation practices fit well to support compensation strategy?
- Does the implementation of compensation practices effectively direct employee behavior to enhance job performance that supports the choice of compensation practices?

Companies base strategy formulation on environmental scanning activities. Discerning threats and opportunities is the main focus of environmental scanning. A threat suggests a negative situation in which loss is likely and over which an individual has relatively little control. An opportunity implies a positive situation in which gain is likely and over which an individual has a fair amount of control.[10]

For instance, many oil and gas extraction companies in the United States are facing threats to market share and profitability as the supply of oil worldwide is increasing more quickly than the demand for it. Saudi Arabia, which is one of the top oil producing countries in the world, continues to pump crude oil, contributing to a glut. Historically, Saudi Arabia limited oil production, which led to lower supply relative to demand, leading to higher prices. The Saudis have departed from business as usual as a rivalry with U.S. energy companies has grown.[11] Extraction and refining processes in the United States are more costly than in most other countries, including Saudi Arabia, which threatens the competitive advantage of the U.S.-based companies extracting and oil refining activities in the United States.

Government regulation provides U.S. pharmaceutical companies with the opportunity to recoup research and development costs as well as generate profits from the sale of products for which they have U.S. patent protection. For a limited period of a few to several years, the U.S. government grants these companies exclusivity. That is, no other company may manufacture or sell the product during this period. Without exclusivity provisions, pharmaceutical companies such as Wyeth Pharmaceuticals would be placed at a competitive disadvantage because other companies would manufacture and distribute a therapeutically equivalent product at a lower cost. For example, Wyeth Pharmaceuticals developed *Protonix*, a product which treats gastro esophageal reflux disease. The company enjoyed exclusivity protection for several years until 2011. The expiration of an exclusivity clause poses a threat for, in this case, Wyeth Pharmaceuticals; yet, an opportunity for more pharmaceutical companies to compete for market share. For example, Teva Pharmaceuticals has been selling pantoprazole, a therapeutically generic version of Protonix, at a lower price. These so-called generic alternatives are less expensive because companies that manufacture and distribute them do not have research and development costs to recoup. Many health insurance companies refuse to provide coverage for brand name products where less expensive generic alternatives are available.

McDonald's, a fast food restaurant chain, is facing at least three noteworthy threats to its future success.[12] First, shifting consumer preferences, particularly among the younger generation in the United States, for healthy food options in a relaxed, casual environment is contributing to McDonald's falling out of favor. While changing preferences are threatening McDonald's future success, restaurant chains like Panera Bread Company are catering to changing preferences.

Second, McDonald's less customizable menu that has a plethora of choices appears to have led to increasing wait times, which is contributing to declining patronage. Third, political tensions between the U.S. and Moscow over the conflict in the Ukraine have led to closing many McDonald's restaurants in those and other foreign countries.[13]

Competitive Business Strategy Choices

Companies use a variety of terms to describe competitive business strategy choices. These choices fundamentally focus on attaining competitive advantage either by achieving lowest cost or product (service) differentiation. In reality, most companies pursue strategies that contain elements of both.

LOWEST-COST STRATEGY The **cost leadership or lowest-cost strategy** focuses on gaining competitive advantage by being the lowest-cost producer of a product or service within the marketplace, while selling the product or service at a price advantage relative to the industry average. Lowest-cost strategies require aggressive construction of efficient-scale facilities and vigorous pursuit of cost minimization in areas such as operations, marketing, and HR.

Ryanair, a low-cost commercial airline based in Ireland, is an excellent illustration of an organization that pursues a lowest-cost strategy because its management successfully reduced operations costs. At least four noteworthy decisions have contributed to Ryanair's goals. First, Ryanair's training and aircraft maintenance costs are lower than similar competitors' costs because the airline uses only Boeing 737 aircraft. Ryanair enjoys substantial cost savings because it does not need to buy different curricula for training flight attendants, mechanics, and pilots to learn about procedures specific to different aircraft makes (e.g., Boeing) and models (e.g., Boeing 747). Second, newer aircraft sport spartan seats that do not recline, have seat-back pockets, or have life jackets stowed under the seat (life jackets are stowed elsewhere on Ryanair planes). Not only does such seating cost less, but it also allows service personnel to clean aircraft more quickly, saving on labor costs. Third, Ryanair airplanes have one toilet to make room for additional passenger seats. Fourth, Ryanair passengers are required to carry their luggage to the plane, reducing the costs of baggage handling.

DIFFERENTIATION STRATEGY Companies adopt **differentiation strategies** to develop products or services that are unique from those of their competitors. Differentiation strategy can take many forms, including design or brand image, technology, features, customer service, and price. Differentiation strategies lead to competitive advantage through building brand loyalty among devoted consumers. Brand-loyal consumers are probably less sensitive to price increases, which enables companies to invest in research and development initiatives to further differentiate themselves from competing companies.

Apple Computer relies on a differentiation strategy to increase market demand and loyalty. Apple's products are successful, in large part, because they have always been designed to be on the leading edge compared to the competition. Even in the face of strong competition, Apple continually excels in creating demand for its products such as iPhones, iPads, and iPods, enabling them control over pricing through product differentiation, innovative advertising, and creative publicity prior to unveiling products.

The following Watch It! video illustrates the basics of competitive business strategy. These concepts, which we've described previously, are illustrated by comparing the strategies of two computer manufacturers, ACER and Hewlett-Packard.

WATCH IT!

If your professor has assigned this, go to the Assignments section of **mymanagementlab.com** to complete the video exercise titled Acer vs. HP: Can Acer Surpass HP?

Compensation Decisions that Support the Firm's Strategy

Compensation professionals support strategic initiatives through the design and implementation of compensation systems. Two broad elements are the basis for compensation professionals' work. These include basic building blocks and structural design elements, which we will indtroduce later in this chapter. For example, compensation professionals make decisions about whether to use (and how to design) pay-for-performance practices, whether setting pay levels that exceed typical market pay rates, and whether to create a pay mix that emphasizes long-term over short-term incentives. The totality of choices should fit well with cost or differentiation objectives and with an eye toward rewarding behaviors that support these objectives.

Employee Roles Associated with Competitive Strategies

Common wisdom and experience tell us that HR professionals must decide which employee roles are instrumental to the attainment of competitive strategies. Knowledge of these required roles should enable HR professionals to implement HR practices that encourage enactment of these roles. Of course, compensation professionals are responsible for designing and implementing compensation practices that elicit strategy-consistent employee roles.

For the lowest-cost strategy, the imperative is to reduce output costs per employee. The desired employee roles for attaining a lowest-cost strategy include repetitive and predictable behaviors, a relatively short-term focus, primarily autonomous or individual activity, high concern for quantity of output, and a primary concern for results. Compared with lowest-cost strategies, successful attainment of differentiation strategies depends on employee creativity, openness to novel work approaches, and willingness to take risks. In addition, differentiation strategies require longer time frames to provide sufficient opportunity to yield the benefits of these behaviors.

BUILDING BLOCKS AND STRUCTURE OF STRATEGIC COMPENSATION SYSTEMS

1-4 Identify and discuss the building blocks and structural elements of strategic compensation systems.

As we discussed previously, extrinsic compensation includes both monetary (core compensation) and nonmonetary rewards (employee benefits). Figure 1-2 lists the main compensation building blocks. The building blocks are embedded within a system of three structural elements that ultimately support compensation strategies. These structural elements include internally

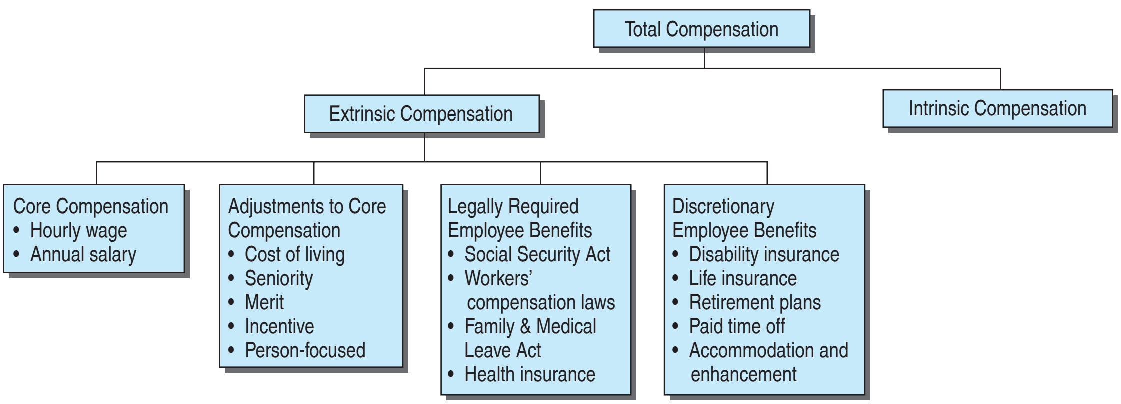

FIGURE 1-2 Compensation System Building Blocks

TABLE 1-1 Elements of Core Compensation

Base Pay

- Hourly pay
- Annual salary

How Base Pay Is Adjusted over Time

- Cost-of-living adjustments
- Seniority pay
- Merit pay
- Incentive pay
- Person-focused pay or competency-based pay: pay-for-knowledge, skill-based pay

consistent job structures, market competitive pay structures, and structures that recognize employee contributions.

Building Blocks: Core Compensation and Employee Benefits

CORE COMPENSATION There are two categories of core compensation: base pay and base pay adjustments over time. The specific practices associated with each category are listed in Table 1-1.

Employees receive **base pay**, or money, for performing their jobs (Chapter 7). Base pay is recurring; that is, employees continue to receive base pay as long as they remain in their jobs. Companies disburse base pay to employees in one of two forms: **hourly pay or wage**, or as **salary**. Employees earn hourly pay for each hour worked. They earn salaries for performing their jobs, regardless of the actual number of hours worked. Companies measure salary on an annual basis. The *Fair Labor Standards Act (FLSA)* (Chapter 2) established criteria for determining whether employees should be paid hourly or by salary. In 2012, the average weekly rate for workers was $818.[14]

Companies typically set base pay amounts for jobs according to the level of skill, effort, and responsibility required to perform the jobs and the severity of the working conditions. Compensation professionals refer to skill, effort, responsibility, and working condition factors as **compensable factors** because they influence pay level (Chapters 2 and 6). Courts of law use these four compensable factors to determine whether jobs are equal per the *Equal Pay Act of 1963 (EPA)*. According to the EPA, it is against the law to pay women less than men for performing equal work though there are exceptions, which we will discuss in Chapter 2. Compensation professionals use these compensable factors to help meet three pressing challenges, which we will introduce later in this chapter: internal consistency (Chapter 6), market competitiveness (Chapter 7), and recognition of individual contributions (Chapter 8).

Over time, employers adjust employees' base pay to recognize increases in the cost of living, differences in employees' performance, or differences in employees' acquisition of job-related knowledge and skills. We will discuss these core compensation elements next.

Cost-of-living adjustments (COLAs) represent periodic base pay increases that are founded on changes in prices as recorded by the Consumer Price Index (CPI). In recent years, the typical COLA equaled approximately 2 to 3 percent annually. COLAs enable workers to maintain their purchasing power and standard of living by adjusting base pay for inflation. COLAs are most common among workers represented by unions. Union leaders fought hard for these improvements to maintain their members' loyalty and support. Many employers use the CPI to adjust base pay levels for newly hired employees.

Seniority pay systems reward employees with periodic additions to base pay according to employees' length of service in performing their jobs (Chapter 3). These pay plans assume that employees become more valuable to companies with time and that valued employees