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Increasing Company Competitiveness: “Tuning-Up” Your Pay System

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Increase Company Competitiveness

"Tune Up" Your Pay System

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The cost of labor (i.e., salaries, benefits and incentives) accounts for a sizeable portion of an employer's operating expenses. Pay packages priced too low or configured improperly can deprive firms of the talent needed to successfully develop, market and produce viable products and services in today's ultra competitive business environment. However, if pay packages are too high, labor costs can weaken a firm's ability to compete. For example, a firm with 500 employees can have labor costs that easily exceed $15 million. Thus, building and maintaining a cost-efficient pay system that encourages employee performance without adversely affecting corporate earnings requires constant vigilance.

During the 1990s, labor scarcity, the opening of new markets, organizational restructuring, technological change, decentralization of pay decisions and changes in pay philosophies triggered development of a variety of new pay programs and distorted many current pay plans. However, the recent downturn in the economy loosened the labor supply and simultaneously created new challenges for organizations – especially in terms of cost control. As a result, a window of opportunity has opened to re-examine your firm's wage/salary, incentive and benefit programs in order to align them with current company goals and to improve cost efficiency. The purpose of such a review is not to propose or endorse sweeping reductions in employee pay or to introduce new pay programs, but rather to refocus existing compensation programs with respect to business strategies, employee needs and labor market realities. For a firm to realign its compensation system, a comprehensive approach must be taken. In other words, it is important to examine pay from several perspectives, including alignment with and support of the business strategy, internal equity, external competitiveness and pay communications.

Alignment with Business or Business Unit Strategy

An entrepreneurial firm that espouses risk taking and seeking new business opportunities should reward employees when the desired outcomes are achieved. When competitive advantage relies on relentless customer service, this behavior should be financially reinforced. If a firm is trying to become the low-cost competitor in a labor-intensive industry, it must decide the best strategy to reduce labor costs, either by paying employees less than industry competitors or by having fewer employees. To determine if alignment exists between competitive strategy and pay/rewards systems, senior management must review and clarify the overall business' strategy for the company or business unit. Given the changes in the business environment over the last decade, including resurgence in the consumer market, increased pace of mergers and acquisitions, and changes in senior leadership, it is likely that many firms' business strategies have been refocused, if not dramatically altered, during the last three to five years. Pay programs can be evaluated and tailored to support strategic goals only when the business strategy has been clearly articulated and understood.

Even in this post-re-engineered, downsized and restructured era, organizations still remain extremely complex and diverse. Different business units within the same company may compete in different industries; industries in which employees share unique skills and where opportunities for returns on investment differ. Intra-organizational diversity of this type strongly suggests that a "one size fits all" pay program would be less effective than a specifically tailored system for each business unit.

For instance, a company competing in two related industries such as apparel and textiles can experience very different staffing and labor cost issues. The apparel industry is labor intensive, involves physically demanding work and has intense competition for customers. On the other hand, the textile industry is less labor intensive and features highly automated production facilities that require far fewer employees. Textile work is less physically demanding and consists primarily of monitoring and troubleshooting the production processes.

This example underscores the difficulty of designing a single pay system for employees working for the same company, but in different industries, that is both internally equitable and externally competitive. Pay levels, incentives and benefits packages need to be customized in order to compete for labor and maintain a cost structure that will allow the firm to compete successfully in producing diverse products and services.

Establishing separate pay systems for diverse business units that serve different industries within a single company is no small undertaking. For instance, lower paid employees from one business unit who interact with higher paid employees from another unit may resent the pay disparities. The decision to implement multi-pay systems is not an easy one, but to do so may make a significant contribution to containing costs and attracting and retaining employees. Overcoming political and organizational inertia to change to multi-pay systems will require commitment and fortitude by senior leadership. A summary of critical review questions for making the decision to have single or multiple pay systems is included in Figure 1 on page 37.

FIGURE 1 "Tuning up" Your Pay System CheckList[1]

Alignment with the Business Strategy

- Have senior management clarify the business strategy for the company of business unit.
- Check each pay program for proper alignment with strategic goals.
- Compare pay programs to determine if they convey consistent messages, especially across occupations and organization levels, and within work units.

Internal Equity

- Use employee attitude surveys, focus groups or interviews to determine if employees perceive a sense of fairness in their pay programs.
- Compare job descriptions with current job duties and responsibilities.
- Examine job evaluation factors and weight to be sure they are aligned with the company's core values and strategic business goals.
- Evaluate jobs to determine if internal rankings are aligned with pay, titles and other rewards.

External Equity

- Check to see if comparison organizations in your pay survey(s) are representative of the labor market within which you compete.
- Check to see if your jobs are comparable to jobs compared in the pay survey.
- Review the quality of survey data you purchase (e.g., Is there high turnover among participating organizations, does the data collected include reliability checks with participating organizations, and are errors in the data frequently discovered?).

Wage and Salary Levels

- Use compa-ratios to determine if current pay practices are consistent with pay goals for work units, departments, occupations, organization levels and other appropriate units.
- Examine individual employee pay to determine if pay levels fall below or above pay ranges, and if consistently high performers are above the mid-point.

Incentive Pay

- Determine if performance criteria or measures are valid and reliable for each incentive program (e.g., are they consistently measuring what they are suppose to measure).
- Determine if eligible employees are capable of affecting the performance criteria.
- Determine if the rewards are large enough and frequent enough (i.e., valued) to motivate desired behaviors.
- Verify that employees perceive that their efforts can affect the desired performance and will be rewarded by utilizing surveys, focus groups or interviews.

Benefits Pay

- Determine if the type of benefits and coverage is competitive with other organizations (i.e., benefits survey).
- Verify that employees understand and value the benefits offered, and that benefits administration is providing good service (e.g., surveys, focus groups or interviews).
- Evaluate suppliers to determine that benefits provided are both cost efficient and meet the service requirements specified in the contracts
- Examine the linkage between benefit programs and business strategies

Communication

- Assess employee understanding of pay philosophy, pay program goals and administrative procedures.
- Examine the quality of communications of pay programs to new employees.
- Examine the quality of employee communications of new pay programs and changes in existing programs.
- Determine if employees trust the pay communications they receive.

[1] Note that a compensation system is the total pay or rewards an employee receives including position pay (e.g., wages and salaries), incentives and benefits. Pay programs, as defined here, represent the individual programs for which an employee is eligible, such as a merit increase plan, group incentive, IRA, etc.

Internal Equity

Given the shortages of skilled employees coupled with the complexity of labor-intensive job evaluation programs, it is understandable why pay programs have been abandoned in favor of "labor market pricing" approaches. Some employees such as information technology professionals, university professors and senior executives may be particularly concerned with what is paid in the external labor market. Others types of employees, especially those with long tenure, may be concerned more with comparing their pay with that of co-workers, supervisors or even subordinates than with the compensation of someone who works for another company (Deutsch, 1985, Werner and Ones, 2000). Taken together, these two observations suggest that a lack of attention to equity with respect to the internal labor market may be occurring, and such inattention may be fraught with dire consequences. Consequently, organizations should consider the following internal comparisons that impact employees' perceptions of pay equity:

- Varying contributions of jobs within the company
- Personal investments employees make to qualify for the job such as education and special certifications

Job evaluation can be used to determine internal equity and to align the company's strategic plan and pay system.

- The effort the job requires, including extensive travel, and weekend or night work
- Required levels of individual or team performance
- General working conditions
- Tenure in the job or company.

Furthermore, research indicates that when employees believe the process used to determine their pay is fair, they are likely to believe that they are fairly paid (Deutsch, 1985). Some managers do not share information on how pay decisions are made and then attempt to limit informal internal comparisons by ordering employees not to share what they are paid with other employees. This strategy seldom works and frequently backfires because employees often conclude that secrecy means that management has something to hide. What's more, pay information informally shared may not be accurate.

Instead of determining pay levels by simply relying on external comparisons, an alternative strategy is to examine internal pay equity. There are three methods that have traditionally been used to assess the internal equity of pay systems. First, employees may be surveyed (i.e., an employee opinion survey) to learn if they perceive the current pay system as fairly rewarding individual skills, contributions, qualifications, tenure and performance levels. However, survey questions must be carefully constructed because it is human nature for employees to place a premium on their own contribution to the organization. Employees may also see the survey as an opportunity to "bargain" for higher wages. To reduce erroneous responses, survey questions should focus on specific comparisons such as "I am paid fairly compared to other employees who do this job," "I am paid fairly compared to employees in other companies who do the same job," and "I am paid fairly compared to my supervisor." To create valid and reliable survey measures, multiple related statements should be used for each measure, and the measures tested statistically using such techniques as coefficient alpha and factor analysis.

Second, jobs can be analyzed to determine their similarities and differences. Systematic job analysis provides specific information about job content, responsibilities and skill requirements. Job knowledge allows for an accurate comparison to be made with other jobs within the company and with similar jobs at other companies. Job information can be collected from supervisors, employees, equipment manufacturers and industry experts. The methods include interviews, job observations and questionnaires (e.g., position analysis questionnaire).

Assuming appropriate job information is collected, job evaluation can be used to determine internal equity and to align the company's strategic plan and the pay system. The most popular method of job evaluation is the point factor method. In short, the point factor method is a technique in which the organization identifies common work attributes for which it is willing to pay. Usually, eight to 12 weighted factors are chosen to measure the value of each job in terms of contribution to the company and employee perceptions of equity. For instance, if innovative product design is a key value and competitive advantage for the company, then the job evaluation system should require innovation as a factor for determining internal equity. Each job would be assessed as to the requirement that an employee be innovative in their work. Figure 1 on Page 37 includes specific questions for evaluating the internal equity of a company's pay system.

However, if pay levels from the external market are the only criteria for assigning value, then the company's pay system will only reflect the values that other organizations have placed on those jobs. Solely relying on the external market will limit management's ability to use compensation to support a business strategy. Figure 1 includes specific questions for evaluating internal equity of a company's pay system.

External Competitiveness

Comments in the previous section not withstanding, external equity can never be ignored if a company is to remain viable. If a firm pays substantially below the labor market, it will be difficult to attract and retain qualified employees. On the other hand, if employees are paid above market wages without an offsetting increase in performance, the additional costs must be reflected in the price of products and services, thereby inhibiting the company's competitiveness.

To determine if current pay practices are positioned properly, organizations should collect or purchase pay survey data that is reflective of the appropriate labor market. These data should be examined periodically to ensure that they represent a timely and accurate snapshot of the relevant labor market. Answering the following questions will assist in this endeavor.

- **Labor market** – Are we comparing ourselves with firms with whom we compete for labor? How do the labor costs reported by the pay survey compare with those of our competitors?
- **Comparable jobs** – Are our jobs comparable with those of other companies included in the pay surveys we use?
- **Reliability of survey data** – Is the accuracy of the data reported by the participating companies checked?

Pay survey data that are purported to be accurate are available on the Internet for many occupations. Unfortunately, these data must be used with caution for a variety of reasons. Data collected may not be verified for accuracy; the data may be collected from job holders who tend to inflate pay levels; and few comparable organizations may have participated in the survey. Despite these shortcomings, employees can easily acquire these data from the Internet and may try to use them to build cases for pay increases. Consequently, it is incumbent upon upper management to articulate explicit criteria for interpreting and evaluating pay survey data to employees, managers and administrators. Specific questions for evaluating external equity of your pay system are included in Figure 1 on Page 37.

Wages and Salaries

Once verified for accuracy, external pay data can then be compared with a company's current wage/salary figures. Where formal pay structures of mid-points, ranges and grades or bands exist, comparison using compa-ratios[1] can be made to determine if employee pay is above or below the desired level. This type of analysis can also be used to determine if groups of individuals with certain characteristics (e.g., race, gender, age) are above or below the mid-point of the corresponding pay ranges. Without a structure in which to frame pay decisions, it is difficult to determine whether pay rates are appropriate.

The decision to pay above, at or below the prevailing market pay levels should be reviewed periodically. If a company is paying above the market, it must ask, "Is the quality of people being attracted really providing added value?" This question can be answered by comparing industry productivity levels, time to market, ROI, EVA and other measures with company data.

Incentive Pay

In recent years incentive or performance pay has begun to play a more important role in compensation packages. Differentiating pay based on some performance criteria requires both clearly defined and well-understood performance standards as well as accurate and applicable performance measures. A variety of performance measures may be obtained (e.g., performance appraisals, customer satisfaction surveys, EVA, profits and a variety of output and quality measures). However, the quality and credibility of performance assessment can vary substantially across organizations and among supervisors within the same organization. The accuracy of performance measurement can be assessed by the answers to these questions:

- *Do performance levels vary as expected?* Performance ratings or outcome measures with little to no variance, either among individuals or teams or over time, is a "red flag." If performance is truly influenced by employees, then variations due to different capabilities and motivation will exist. If there are no variations, it may be that either the performance criteria or the evaluation instrument is not making appropriate distinctions among employees, teams or facilities. This condition is more likely to exist with respect to subjective performance appraisals. Supervisors may not make performance distinctions for a variety of reasons. These include, but are not limited to, lack of training, lack of time, lack of incentive or wishing to avoid employee animosity toward themselves or other employees.
- *Are performance levels consistent across genders, races and ages?* Significant variation in performance evaluations between these and other specified groups may indicate that measurement biases are occurring. Further analysis of performance data, interviews, focus groups and surveys can be used to determine the causes of these differences.
- *Do employees feel that their performance ratings and criteria are fair?* The majority of exempt employees are evaluated based on their individual performance; however, research indicates they often feel that the performance appraisal process is biased (Hills, Madigan, Scott & Markham, 1987). Performance measurement systems that are perceived as biased or unfair are inherently flawed since employees respond to what they perceive rather than to what is actually occurring.

In addition to closely scrutinizing performance measures, incentive programs need to be examined with respect to several characteristics. First, are the performance criteria aligned with business strategy, as discussed previously? Second, are employees' eligibility to participate consistent with their ability to affect performance? Plan eligibility is of particular importance because if employees declared to be eligible cannot affect the performance criteria, then the goals of the program will be jeopardized because the rewards are likely to be unnecessarily diluted. Conversely, if employees who can affect the performance criteria are excluded, the program may fail because these employees will be discouraged from making contribution within their capability.

Third, are the amount and frequency of the awards appropriate to the plan's objective? For one thing, are the incentive pay program awards worth the additional employee effort to earn them? For another, are these payouts made with enough frequency so the connection between performance and rewards are clear to participants? Unless incentives are viewed as worthwhile, attainable and fairly distributed, they will have little impact on performance.

Benefits

Some benefits are legally required (e.g., workers' compensation, Social Security and unemployment insurance). Others, though not legally required, are expected by employees (e.g., life and health insurance, sick days, retirement savings and vacations), and some are perceived as nice perks that may not be available elsewhere (e.g., company car, pet care and legal insurance). Carefully structured benefit programs can substantially enhance efforts to attract and retain qualified employees. A comparison of the types and funding levels of benefits offered by companies that compete for the same labor or customers can offer considerable insight into the type of benefit package that is desirable. However, an assessment of how current company benefits are communicated to employees, how employees perceive these benefits and how these benefits are linked to the business strategy is probably more important. If management believes that retaining employees for the long term is a competitive advantage, it should emphasize benefits such as vacation, retirement funding and perks that reward tenure.

In recent years, it has become fashionable to communicate the monetary value of benefits to employees. However, employees may not understand why certain benefits were selected. Also, some benefits may be more desirable than others for certain employees. Determining how employees perceive the type and level of benefits they receive can be determined through interviews, focus groups and employee attitude surveys. Once again, one must carefully word these questions such that they do not imply that additional benefits will necessarily be forthcoming.

Communications

Pay systems reinforce management priorities and convey powerful messages as to appropriate employee behavior. For example, suppose management desires employees to engage in team-focused behavior and even provides team training to help them do so. Suppose further that the organization is using a merit pay system that rewards individual performance. In such a case employees would be receiving conflicting messages and may have to decide, "Should I work for the benefit of the team or should I pursue individual rewards, even at the expense of team objectives?" As this example illustrates, aligning the pay system with company strategy, while necessary, is not sufficient. The values and assumptions underlying the overall compensation system, as well as the purpose and mechanics of specific pay programs, must be clearly communicated and understood by employees. If these dimensions of the pay system are not well understood, then neither will be the messages that the system was designed to convey. Furthermore, when employees do not know what is valued and rewarded by the company, frustration and even hostility can result when expected rewards are not forthcoming.

There are three fundamental ways to determine the effectiveness of pay communications. First, examine the timeliness and relevancy of employee communications on all new and existing pay programs. Using a variety of communication channels will increase the chances that employees will understand messages sent to them. Communication methods and content should differ for different employee groups, such as production hourly, office hourly and professional. Examining the clarity, frequency, and content of communications can result in good initial quality assessment of the company's pay communication.

Second, in order to determine if pay messages are reaching employees, ask them. Interviews, group meetings or employee attitude surveys are ideal ways to garner this information. If trust in management is low, it may be difficult to collect unbiased information unless respondent anonymity is assured. Responses to surveys, interviews and group meetings can be collected, analyzed and presented by an outsider in order to help employees feel secure about their anonymity.

Finally, one can confirm that pay programs motivate and reward the desired behavior and outcomes. To establish this link, performance data for those who receive the rewards must be collected and examined. Comparisons can be made between those who receive the rewards and those who do not. Also, the performance of those who receive the rewards can be compared to their own performance as it was before the incentives were offered (i.e., time series analysis). If significant differences are not found, then either the pay plan is flawed or it was not explained properly.

In terms of understanding the pay program, Lee, Law, and Bobko (1999) found that employees who understand their pay plans perceive these plans as being more effective. Furthermore, employee feelings of pay equity are often not the result of the amount they are paid but rather their perception of how management arrives at pay levels. Thus, employees need to have confidence that management uses a systematic, unbiased approach to establishing pay levels. This includes the use of fair internal pay criteria, positioning pay at correct levels in comparison to the relevant labor market, and fairly distributing merit increases and rewards.

Conclusion

Wages/salaries, incentives and benefits are major costs of doing business; they are more than just necessary expenses. Pay systems that are aligned with a company's strategic goals and philosophies can provide it with a competitive advantage, both in terms of overall labor cost saving and enhanced productivity and effectiveness. However, there are numerous forces that can distort pay systems. Consequently, it is important to periodically retune pay programs in order to get full value. The old adage is true that "you get what is rewarded but not always what is desired." Given the cost of labor, it behooves management to carefully scrutinize pay programs in order to ensure that they are getting what is desired. WJ

Webnotes

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Endnotes

[1] The midpoint of a range for a salary grade, department or occupational group represents the average amount the employer plans to pay. The compa-ratio equals the average rates actually paid divided by range midpoint. A compa-ratio above 1.00 means employees are being paid on average more than management had planned; whereas a compa-ratio less than 1.00 means that employees are being paid less than intended.