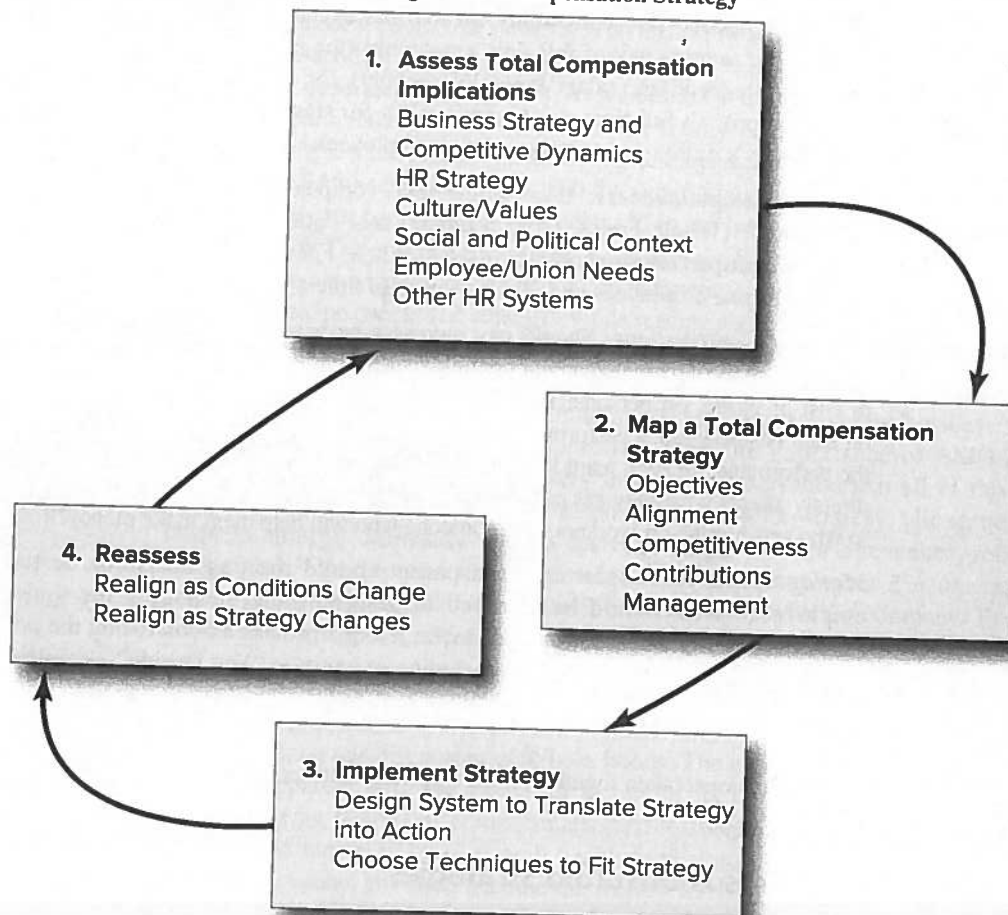


they have a compensation strategy. Ask a manager at one of these latter organizations about its compensation strategy and you may get a pragmatic response: "We do whatever it takes." Its compensation strategy is inferred from the pay decisions it has made.²⁶ Managers in all organizations make the five strategic decisions discussed earlier. Some do it in a rational, deliberate way, while others do it more chaotically—as ad hoc responses to pressures from the economic, sociopolitical, and regulatory context in which the organization operates. But in any organization that pays people, there is a compensation strategy at work.

DEVELOPING A TOTAL COMPENSATION STRATEGY: FOUR STEPS

Developing a compensation strategy involves four simple steps, shown in Exhibit 2.6. While the steps are simple, executing them is complex. Trial and error, experience, and insight play major roles. Research evidence can also help.²⁷

EXHIBIT 2.6 Key Steps in Formulating a Total Compensation Strategy



Step 1: Assess Total Compensation Implications

Think about any organization's past, present, and—most vitally—its future. What factors in its business environment have contributed to the company's success? Which of these factors are likely to become more (or less) important as the company looks ahead? Exhibit 2.6 classifies the factors as competitive dynamics, culture/values, social and political context, employee/union needs, and other HR systems.

Business Strategy and Competitive Dynamics—Understand the Business

This first step includes an understanding of the specific industry in which the organization operates and how the organization plans to compete in that industry. This corresponds with the first two decisions in Exhibit 2.2: What business should we be in, and how do we win in that business?²⁸ To cope with the turbulent competitive dynamics, focus on what factors in the business environment (i.e., changing customer needs, competitors' actions, changing labor market conditions, changing laws, globalization) are important today. What will be important in the future?

What is your company's strategy? How do you compete to win? How should the compensation system support that strategy? Learn to gauge the underlying dynamics in your business (or build relationships with those who can). We have already discussed aligning different compensation strategies with different business strategies using the examples of cost cutter, customer centered, and innovator (Exhibit 2.3). But be cautious: As we have already pointed out, reality is more complex and chaotic. Organizations are innovators *and* cost cutters *and* customer centered. All three, and more. The orderly image conveyed in the exhibits does not adequately capture the turbulent competitive dynamics underlying this process.²⁹

Competitive dynamics can be assessed globally.³⁰ However, comparing pay among countries is complex. In Chapter 1, we noted differences in hourly labor costs and productivity (output per dollar of wages) among countries. But as we shall see in Chapter 16 on global pay, countries also differ on the average length of the workweek, the average number of paid holidays, the kinds of national health care and retirement programs, and even how pay is determined. Nevertheless, managers must become knowledgeable about competitive conditions both globally and locally.

HR Strategy: Pay as a Supporting Player or Catalyst for Change?

As noted earlier, the pay strategy is also influenced by how it fits with other HR systems in the organization.³¹ Whatever the overall HR strategy, a decision about the prominence of pay in that HR strategy is required. Pay can be a supporting player, as in the high-performance approach, or it can take the lead and be a catalyst for change. Whatever the role, compensation is embedded in the total HR approach.³²

So, the compensation implications of all the above factors—the organization's business strategy, global competitive dynamics, culture and values, the sociopolitical context, employee preferences, and how pay fits with other HR systems—all are necessary to formulate a compensation strategy.

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EXHIBIT 2.7 Medtronic Values

Written more than 30 years ago, our mission statement gives purpose to our work, describes the values we live by, and is the motivation behind every action we take.

1. To contribute to human welfare by application of biomedical engineering in the research, design, manufacture, and sale of instruments or appliances that alleviate pain, restore health, and extend life.
2. To direct our growth in the areas of biomedical engineering where we display maximum strength and ability; to gather people and facilities that tend to augment these areas; to continuously build on these areas through education and knowledge assimilation; to avoid participation in areas where we cannot make unique and worthy contributions.
3. To strive without reserve for the greatest possible reliability and quality in our products; to be the unsurpassed standard of comparison and to be recognized as a company of dedication, honesty, integrity, and service.
4. To make a fair profit on current operations to meet our obligations, sustain our growth, and reach our goals.
5. To recognize the personal worth of employees by providing an employment framework that allows personal satisfaction in work accomplished, security, advancement opportunity, and means to share in the company's success.
6. To maintain good citizenship as a company.

Culture/Values

A pay system reflects the values that guide an employer's behavior and underlie its treatment of employees. The pay system mirrors the company's image and reputation. As we noted in Chapter 1, most companies publish a values statement on their websites. Medtronic publishes theirs in 24 languages. Part of it is in Exhibit 2.7. Medtronic's value #5 recognizes employees' worth by fostering "personal satisfaction in work accomplished, security, advancement opportunity, and means to share in the company's success." Its compensation strategy reflects this value by including work/life balance programs for security, incentives, and stock ownership to share the company's success.

But there are some skeptics out there. Mission statements have been described as "an assemblage of trite phrases" which impressed no one.³³ In contrast, Johnson and Johnson considers its statement its "moral compass" and "recipe for business success."³⁴

Social and Political Context

Context refers to a wide range of factors, including legal and regulatory requirements, cultural differences, changing workforce demographics, expectations, and the like. These also affect compensation choices. In the case of Whole Foods, its business is very people-intensive. Consequently, Whole Foods managers may find that an increasingly diverse workforce and increasingly diverse forms of pay (child care, chemical dependency counseling, educational reimbursements, employee assistance programs) may add value and be difficult for competitors (other supermarkets) to imitate.

Because governments are major stakeholders in determining compensation, lobbying to influence laws and regulations can also be part of a compensation strategy. In the United States, employers will not sit by while Congress considers taxing employee benefits. Similarly, the European Union's "social contract" is a matter of interest.³⁵ And in China, every foreign company has undoubtedly discovered that building relationships

with government officials is essential. So, from a strategic perspective, managers of compensation may try to shape the sociopolitical environment as well as be shaped by it.

Employee Preferences

The simple fact that employees differ is too easily overlooked in formulating a compensation strategy. Individual employees join the organization, make investment decisions, interact with customers, design new products, assemble components, and so on. Individual employees receive the pay. A major challenge in the design of next-generation pay systems is how to better satisfy individual needs and preferences. Offering more choice is one approach. Older, highly paid workers may wish to defer taxes by putting their pay into retirement funds, while younger employees may have high cash needs to buy a house, support a family, or finance an education. Dual-career couples who have double family coverage may prefer to use more of their combined pay for child care, automobile insurance, financial counseling, or other benefits such as flexible schedules. Employees who have young children or dependent parents may desire dependent care coverage.³⁶ Whole Foods, in fact, as described in its annual report each year, holds an employee vote every three years to determine the nature of their benefits program.

Based on the opinions of 10,000 U.S. workers, Hudson found that:

- Nearly three out of four U.S. workers claim to be satisfied with their compensation, yet a large portion of the same sample (44%) say they would change their mix of cash and benefits if given the chance.
- When given their choice of unconventional benefits, most employees would select a more flexible work schedule (33%) or additional family benefits (22%), including parental leaves and personal days, over job training (13%) or supplemental insurance (16%).
- One in five workers say better health care benefits would make them happier with their compensation package. On the other hand, 41 percent said that the single thing that would make them happier is more money.³⁷

*Choice Is Good. Yes, No, Maybe?*³⁸

Contemporary pay systems in the United States do offer some choices. Flexible benefits and choices among health care plans and investment funds for retirement are examples. As we saw earlier, Whole Foods employees vote on the benefits they want. Netflix employees can choose the mix of stock options and salary. General Mills similarly allows many employees to swap several weeks' salary for stock awards. The company believes that allowing employees their choice adds value and is difficult for other companies to imitate—it is a source of competitive advantage for General Mills. Whether or not this belief is correct remains to be studied.

Some studies have found that people do not always choose well. They do not always understand the alternatives, and too many choices simply confuse them. Thus, the value added by offering choices and satisfying preferences may be offset by the expense of communicating and simply confusing people.³⁹

In addition to possibly confusing employees, unlimited choice would be a challenge to design and manage. Plus, it would meet with disapproval from the U.S. Internal

Revenue Service (health benefits are not viewed by the IRS as income). Offering greater choice to employees in different nations would require meeting a bewildering maze of codes and regulations. On the other hand, the U.S. federal government, including the IRS, already offers its employees a bit of choice in their work schedules. Forty-three percent avail themselves of the option to take compensatory time off for extra hours worked. In contrast, U.S. private sector workers covered by the Fair Labor Standards Act (i.e., **nonexempt** employees) must be paid time-and-a-half overtime if they work over 40 hours in a week. A compensatory time option is not permitted.⁴⁰

Union Preferences

Pay strategies need to take into account the nature of the union-management relationship.⁴¹ Even though union membership among private-sector workers in the United States is now less than 10 percent of the workforce, union influence on pay decisions remains significant, especially in key sectors (e.g., manufacturing, health care, education). Union preferences for different forms of pay (e.g., protecting retirement and health care plans) and their concern with job security affect pay strategy.

Unions' interests can differ. In Denver, Colorado, a merit pay plan was developed collaboratively by the Denver Public Schools and the Denver Classroom Teachers Association, the local union affiliate. Teachers approved the agreement by a 59 to 41 percent vote, and Denver voters approved a \$25 million property tax increase to pay for it. Conversely, many teachers in Springfield, Massachusetts, left for neighboring, higher-paying school districts in part because the district wanted to impose a merit pay plan.⁴²

Compensation deals with unions can be costly to change. The U.S. auto companies negotiated "The Jobs Bank" program that began in 1984 with the United Auto Workers. Employees who were no longer needed to make cars continued to get paid until they were needed again. Some received up to \$100,000 a year, including benefits. Their job: Do nothing but wait for a job to open. But for a number of people, those jobs never materialized. In various cities around the U.S., about 15,000 employees showed up at 6 a.m. each day and stayed until 2:30 p.m. with 45 minutes off for lunch. Some volunteered for approved community projects or took classes. Jerry Mellon claims, "They paid me like \$400,000 over 6 years to learn how to deal blackjack."⁴³ Readers may wonder if the Jobs Bank was a compensation strategy that trumped the business strategy. No wonder GM eventually bought its way out of the Bank. No wonder GM recently found it necessary to go through bankruptcy.

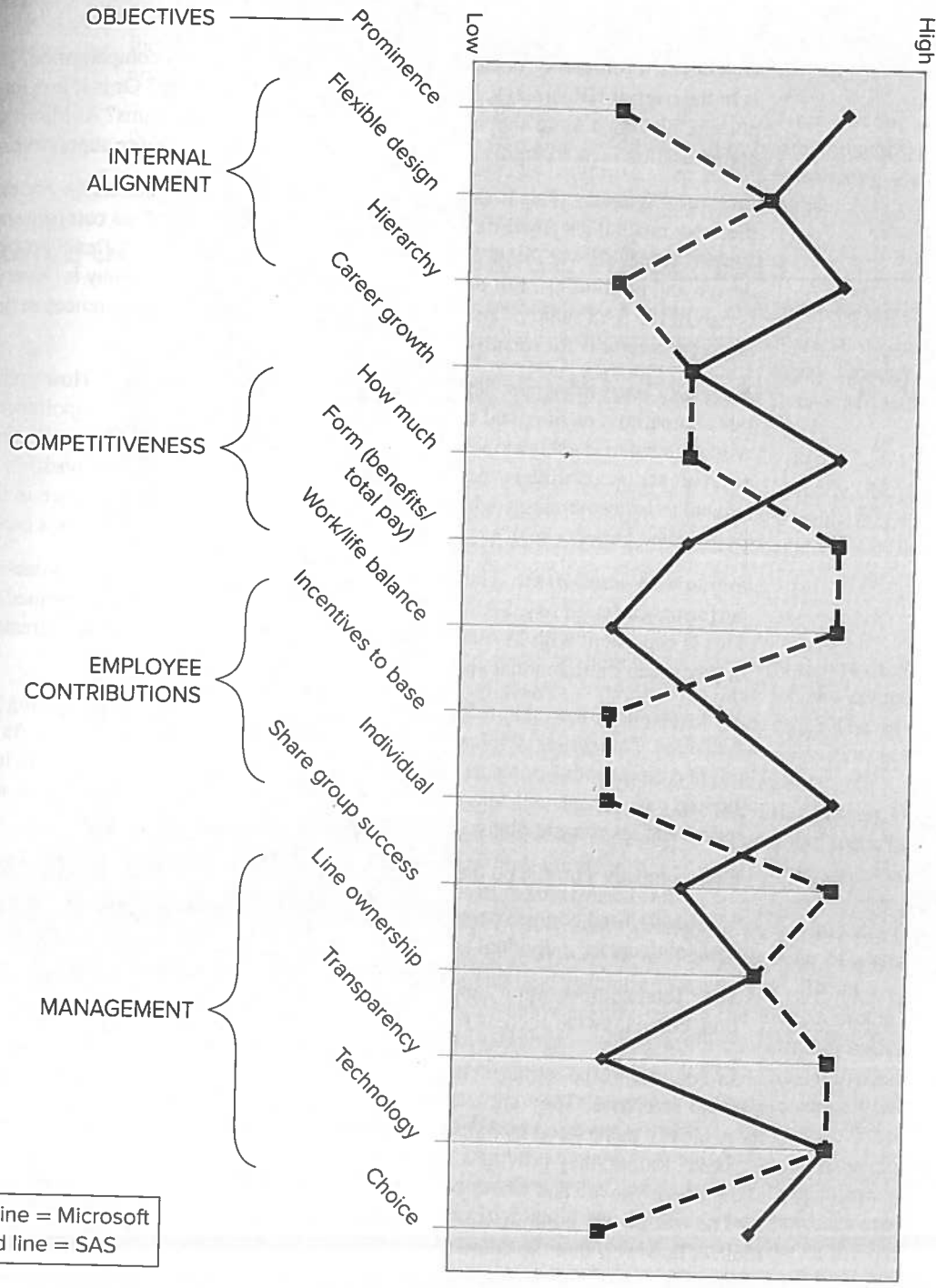
Step 2: Map a Total Compensation Strategy

The compensation strategy is made up of the elements in the pay model: objectives, and the four policy choices of alignment, competitiveness, contributions, and management. Mapping these decisions is Step 2 in developing a compensation strategy.

Mapping is often used in marketing to clarify and communicate a product's identity. A strategic map offers a picture of a company's compensation strategy. It can also clarify the message that the company is trying to deliver with its compensation system.

Exhibit 2.8 maps the compensation strategies of Microsoft and SAS. The five dimensions are subdivided into a number of descriptors rated on importance. These ratings are from your fearless (read "tenured") authors. They are not ratings assigned

EXHIBIT 2.8 Contrasting Maps of Microsoft and SAS



by managers in the companies. The descriptors used under each of the strategy dimensions can be modified as a company sees fit.

Objectives: Prominence is the measure of how important total compensation is in the overall HR strategy. Is it a catalyst, playing a lead role? Or is it less important, playing a more supporting character to other HR programs? At Microsoft, compensation is rated highly prominent, whereas at SAS it is more supportive.

Internal Alignment: This is described as the degree of internal hierarchy. For example, how much does pay differ among job levels and how well does compensation support career growth? Both SAS and Microsoft use pay to support flexible work design and promotions. But pay differences at SAS, whose philosophy is “Everyone is part of the SAS family,” are smaller than at Microsoft, where differences in pay are seen as returns for superior performance.

External Competitiveness: This includes comparisons on two issues. How much are our competitors paying, and what forms of pay are they using? The importance of work/life balance achieved via benefits and services is also part of external competitiveness. According to the strategy map, Microsoft’s **competitive position** is critical to its pay strategy, whereas SAS competes on work/family balance in family-oriented benefits such as private schools and doctors on the company’s campus.

Employee Contributions: These two companies take a very different approach to performance-based pay. SAS uses only limited individual-based performance pay. This is consistent with its overall egalitarian approach. Microsoft makes greater use of pay based on individual and company performance.

Management: Ownership refers to the role non-HR managers play in making pay decisions. *Transparency* refers to openness and communication about pay. As one might expect, both Microsoft and SAS rate high on the use of technology to manage the pay system, and Microsoft offers greater choices in their health care and retirement investment plans.

Each company’s profile on the strategy map reflects its main message or “pay brand”:

Microsoft: Total compensation is prominent, with a strong emphasis on market competitiveness, individual accomplishments, and performance-based returns.

SAS: Total compensation supports its work/life balance. Competitive market position, companywide success sharing, and egalitarianism are the hallmarks.

In contrast to the verbal description earlier in this chapter, strategic maps provide a visual reference. They are useful in analyzing a compensation strategy that can be more clearly understood by employees and managers.⁴⁴ Maps *do not* tell which strategy is “best.” Rather, they provide a framework and guidance. Just like a road map, they can show where you are and where you are going.⁴⁵

The rest of this book discusses compensation decisions in detail. It is important to realize, however, that the decisions in the pay model work in concert. It is the totality of these decisions that forms the compensation strategy.

Steps 3 and 4: Implement and Reassess

Step 3 in Exhibit 2.6 is to implement the strategy through the design and execution of the compensation system. The compensation system translates strategy into practice—and into people's bank accounts.

Step 4, Reassess and Realign, closes the loop. This step recognizes that the compensation strategy must change to fit changing conditions. Thus, periodic reassessment is needed to continuously learn, adapt, and improve. The results from using the pay system need to be assessed against the objectives we are trying to achieve.

SOURCE OF COMPETITIVE ADVANTAGE: THREE TESTS

Developing and implementing a pay strategy that is a source of sustained competitive advantage is easier said than done. Not all compensation decisions are strategic or a source of competitive advantage. Three tests determine whether a pay strategy is a source of advantage: (1) Is it aligned? (2) Does it differentiate? (3) Does it add value?

Align

Alignment of the pay strategy includes three aspects, as we have already discussed: (1) align with the business strategy, (2) align externally with the economic and socio-political conditions, and (3) align internally within the overall HR system. Alignment is probably the easiest test to pass.

Differentiate

Some believe that the only thing that really matters about a strategy is how it is different from everyone else's. If the pay system is relatively simple for any competitor to copy, then how can it possibly be a source of competitive advantage? The answer, according to the advocates of the strategic approach, is in how the pay system is managed. This rhetoric is appealing, but the evidence to support it is slim.⁴⁶

The map profiles in Exhibit 2.8 show how Microsoft and SAS differ in their strategies. One uses pay as a strong signal; the other uses pay to support its "work/family balance" HR strategy. Both organizations claim to have organization cultures that value performance, yet their compensation strategies differ.

Are they difficult to imitate? Probably, since each strategy is woven into the fabric of the company's overall HR strategy. Copying one or another dimension of a strategy means ripping apart the overall approach and patching in a new one. So, in a sense, the alignment test (weaving the fabric) helps ensure passing the differentiation test. Microsoft's use of stock awards for all employees—often worth considerably more than people's base pay—is difficult for its competitors to copy. SAS's work-family-balance (like Medtronic's total-presence-at-the-workplace strategy) is difficult to copy. It may be relatively easy to copy any individual action a competitor takes (i.e., grant stock options to more employees or offer more choice in their health insurance). But the strategic perspective implies that it is the way programs fit together and fit the overall organization that is hard to copy. Simply copying others by blindly benchmarking best practices amounts to trying to get in and/or stay in the race, not win it.⁴⁷ (Of course, being in the race, or achieving competitive parity, may be a major improvement for some organizations.)