Compensation Management

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Learning Outcomes

After studying this chapter, you should be able to do the following:

10.1 Identify the components of a compensation system. Page 254
10.2 Describe how expectancy and equity theories apply to compensation. Page 255
10.3 Identify the seven basic issues that make up the organizational compensation strategy. Page 257
10.4 Discuss the three major provisions of the Fair Labor Standards Act (FLSA). Page 259
10.5 Name the three types of job evaluations by describing whether they are more objective or subjective in form. Page 264
10.6 Briefly describe the concept of job structure, pay levels, product market competition, and labor market competition. Page 266
10.7 Briefly describe the concept of a pay structure, including broadbanning and delayering. Page 266

SHRM HR Content

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B. Compensation and Benefits

Compensation
   1. Compensation of special groups (e.g., executives, sales, contingent workers, management)
   2. Determining pay increases
   3. Development of a base pay system
   4. Developing pay levels
   5. External competitiveness strategies
   6. Fair Labor Standards Act (FLSA)
   7. Internal alignment strategies
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   9. Job evaluation and compensation (grades, pay surveys, and pay setting)
   10. Labor market competition
   11. Legal constraints on pay issues
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   15. Monitoring compensation costs
   16. Motivation theories: Equity theory, reinforcement theory, agency theory, expectancy theory
   17. Pay discrimination and dissimilar jobs
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   21. Role of job analysis/job design/job descriptions in determining compensation
   22. Skill-based pay
   24. Union role in wage and salary administration

D. Employment Law

I. Job Analysis and Job Design
   1-b. Compliance with legal requirements—Equal pay (skill, effort, responsibility, and working conditions) and comparable worth
   1-c. Compliance with legal requirements—Overtime eligibility (exempt vs. nonexempt work)
   3. Job evaluation and compensation (grades, pay surveys, and pay setting)

K. Metrics and Measurement of HR
   3. Benchmarking

N. Staffing (Recruitment and Selection)
   4. Employment brand

Practitioner’s Perspective

Cindy tells the story of when Drew walked dejectedly into her office and flopped down in the nearest chair.

“I hear they hired a new payroll clerk—the same job I’ve been doing for 5 years—and this new person is going to be paid more than I make! I’ve been a loyal employee for years and haven’t had a real raise since I started. Is that fair?”

Cindy couldn’t fault Drew for his feelings, and she knew it was past time the company examined its compensation guidelines.

Once you have an established pay scale, is it really important to reexamine your compensation levels? What is the solution when the going market rate for a position outdistances your set pay scale? Chapter 10 answers these questions and more as it demonstrates the reasons why compensation management is so vital to attracting and retaining your best employees.
Compensation Management

LO 10.1 Identify the components of a compensation system.

Employees are the most important company asset, so we have to recruit and train the best people, and minimizing turnover improves job and financial performance. How do we retain our good employees? Meeting employee needs helps, and an important factor is compensation. Compensation is the total of an employee’s pay and benefits. How important is compensation to you?

A business designs and implements a compensation system to focus worker attention on the specific efforts the organization considers necessary to achieve its desired goals. According to recent research by Payscale, “Compensation has officially expanded from ‘just a human resources issue’ to a C-suite issue,” with about 57% of respondents saying that compensation is becoming more important to executives and that it has strategic value to the firm.

One reason for C-suite concern is that compensation costs are frequently the largest part of total production costs at today’s firms. Thus, management must continually monitor and manage total organizational compensation. Compensation costs also continue to rise as companies face shortages of skilled talent as world economies continue to expand. According to the U.S. Bureau of Labor Statistics, average total compensation costs rose from $31.93 to $36.22 per hour from March 2014 to June 2018.

Compensation also affects the process of both attracting and retaining employees. Pay is now identified by employees as the top reason for job satisfaction, overtaking job security as the top driver of satisfaction in 2013. In fact, pay is second in importance overall (respectful treatment is number one) to all four generations of employees currently in the workforce—veterans, baby boomers, Generation X, and millennials—so HR must pay attention to fair and equitable compensation for company employees.

The Compensation System

The compensation system of an organization includes anything an employee may value and desire and that the employer is willing and able to offer in exchange. This includes the following:

1. Direct compensation components. All rewards that can be classified as monetary payments and in-kind payments constitute the direct compensation component. In-kind means that we exchange something of value (in this case our work time) for other things of value, instead of getting cash payments. So, for instance, free company-paid housing and free meals at work would be in-kind payments, because providing housing and meals provides value to the employees.

2. Nonmonetary compensation components. All rewards other than monetary and in-kind payments constitute the nonmonetary compensation component, even if the company pays money to others (e.g., a health insurer) on behalf of the employee.

Types of Compensation

There are four basic parts of a compensation system:

1. Base pay. This is typically a flat rate, either as an hourly wage or salary. Many employees consider this to be the most important part of the compensation program, and it is therefore a major factor in their decision to accept or decline the job.

2. Wage and salary add-ons. This includes overtime pay, shift differential, premium pay for working weekends and holidays, and other add-ons.

3. Incentive pay. Also called variable pay, incentive pay is pay for performance, and it commonly includes items such as piecework, merit pay, and commissioned sales. We will discuss incentives in detail in Chapter 11.

4. Benefits. This is compensation that provides something of value to the employee. Some benefits are part of in-kind payments (the company-paid housing mentioned earlier, for
instance), and therefore part of direct compensation. Others are in the nonmonetary compensation component (life insurance, being allowed to take pets to work, or vacation time would be examples). Benefits may include health insurance; payments to employees if they are unable to work because of sickness or accident; retirement pay contributions; and provision of a wide variety of desired goods and services such as cafeteria service, tuition reimbursement, and many other items. We will also discuss benefits in detail in Chapter 11.

In for-profit businesses, we want to design the mix of direct and nonmonetary compensation that provides us with the best productivity return for the money spent. However, to do that, we need to understand something about the motivational value of our compensation system. Let’s take a look at a few theories that help us understand how compensation systems can motivate our workers to perform to the best of their ability.

### 10.1 APPLYING THE CONCEPT

#### TYPES OF COMPENSATION

<table>
<thead>
<tr>
<th>Review the types of compensation and then write the letter corresponding to each one before the statement(s) describing it.</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Base pay</td>
</tr>
<tr>
<td>b. Wage and salary add-ons</td>
</tr>
<tr>
<td>c. Incentive pay</td>
</tr>
<tr>
<td>d. Benefits</td>
</tr>
<tr>
<td>1. I’d like to work for a firm that will help pay for me to get my master of business administration (MBA) degree.</td>
</tr>
<tr>
<td>2. I only get paid $11 an hour, so I’m looking for a better job.</td>
</tr>
<tr>
<td>3. I like getting paid the same each week. It helps me to budget my expenses.</td>
</tr>
<tr>
<td>4. I like being paid for every sale I make, but my pay does vary from week to week.</td>
</tr>
<tr>
<td>5. I like working nights because it pays more.</td>
</tr>
</tbody>
</table>

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### Motivation and Compensation Planning

> **LO 10.2 Describe how expectancy and equity theories apply to compensation.**

When we look at designing compensation programs, we need to remember that we are trying to motivate the employee to do the things we need them to do, consistently, over a period of time. However, “while 73 percent of employers say they pay their workers fairly, only 36 percent of employees agree.”

Why does this result exist? Probably the most significant theories that help you to understand compensation planning and employee motivation are **expectancy theory** and **equity theory**. (SHRM B:16)

#### Expectancy Theory

Expectancy theory is a process theory of motivation. This means that we go through a cognitive process to evaluate something or a situation. **Expectancy theory proposes that employees are motivated when they believe they can accomplish a task and that the rewards for doing so are worth the effort.** Expectancy theory is based on Victor Vroom’s formula: **Motivation = Expectancy × Instrumentality × Valence.**

For compensation purposes, we have intentionally simplified the theory to show how it affects a person’s motivation to perform. **Expectancy** is the person’s perception of their ability to accomplish or probability of accomplishing an objective. Generally, the higher one’s expectancy, the

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better the chance for motivation. Instrumentality is the perception that a particular level of performance is likely to provide the individual with a desired reward. Valence refers to the value a person places on the outcome or reward, because not all people value the same reward. So, it helps to let employees have a voice in the rewards they get. One thing we need to remember here is that the three components of the theory—valence, instrumentality, and expectancy—are multiplicative, so if any one of the three is near zero, the motivating potential is low, and the individual has almost no motivation to perform! For an illustration of expectancy in action, see Exhibit 10.1. Therefore, as managers, if we help employees get what they want, they will give us the work we want to help meet the organizational goals.

**EXHIBIT 10.1 • Expectancy Theory and Compensation**

![Expectancy Theory Diagram](image)

**Equity Theory**

We all apply equity theory constantly. Equity theory, particularly the version developed by J. Stacy Adams, proposes that people are motivated to seek social equity in the rewards they receive (outcomes) in exchange for their performance (input). So in general, equity theory proposes that employees are motivated when the ratio of their perceived outcomes to inputs is at least roughly equal to that of other referent individuals. Employees are more motivated to achieve organizational objectives when they believe they are being treated fairly, especially regarding pay equity.

According to equity theory, people compare their inputs (effort, loyalty, hard work, commitment, skills, ability, experience, seniority, trust, support of colleagues, etc.), their financial rewards (pay, benefits, and perks), and intangible outcomes (praise, recognition, status, job security, sense of advancement and achievement, etc.) to those of relevant others. A relevant other could be a coworker or a group of employees from the same or different organizations.

Notice the definition says that employees compare their perceived (not actual) inputs and outcomes. Equity may actually exist, but if employees believe there is inequity, they will change their behavior to create what they consider to be equity. Employees must perceive that they are being treated fairly, relative to others. Managers can also help control employee perceptions of fairness through honest discussion of compensation. Perceptions of inequity hurt attitudes, commitment, and cooperation, thereby decreasing individual, team, and organizational performance. This perceived inequity is often used as a justification for unethical behavior. When employees perceive inequity, they are motivated to reduce it by decreasing input or increasing outcomes or they leave for another job.

Remember this: We want to be treated fairly, with mutually beneficial relationships. Employees’ perception of being treated fairly affects their attitude and performance. People are generally not really motivated to work harder by equity; rather, they are demotivated if it doesn’t exist. So HR managers need to understand that people will be demotivated if they feel (perceive) that they are not being treated fairly. Unfair and abusive managers demotivate employees and...
hurt performance. We need to be honest and fair to develop trusting relationships to motivate others, especially regarding compensation. As a result, we have to use this information when we begin to structure our compensation plan. We need to “build in” and advertise equity to minimize the problems associated with equity theory. Companies like Nike are working on equity compensation, especially for women and minorities.

Compensation Strategy

LO 10.3 Identify the seven basic issues that make up the organizational compensation strategy.

In addition to understanding our compensation options and how they motivate employees, we need to identify what our overall compensation strategy will be. Let’s discuss some of these major organizational issues that we will need to evaluate before we can set up our compensation system.

Ability to Pay

Probably the first thing we need is an honest assessment of how much we can afford, or are willing to afford, to pay our employees. This means we need to complete an assessment of estimated revenues from business operations and determine what percentage of revenues can or should realistically go toward compensation costs over the long term. Why? Because if we have to cut compensation, employees may believe we broke our promises to them, and that will most likely lead to intense demotivation and high rates of turnover.

At, Above, or Below the Market?

The next item we must determine, based on our ability to pay, is whether we will pay above market, at market, or below market. We will need to know the market compensation offered by our competitors. Competitors will sometimes advertise job salaries, and you can use pay calculators including Glassdoor.com, PayScale.com, and others for free. (SHRM N:4)

We might decide to pay above market to attract better workers and enhance our employment brand. We want good employees to have a strong incentive to work for us, and one way to enhance our employment brand is to pay above the market rate. We also want better productivity out of our workforce if we pay more for employees. But do better workers generally have higher levels of productivity? Efficiency wage theory says that if a company pays higher wages, it can generally hire better people who will in turn be more productive. Because we have higher-quality employees, we get a productivity increase that more than offsets the higher cost of employing them.

Would we necessarily get lower productivity from our workforce if we paid below the market? In general, yes, but not always. If our firm is in an industry where unemployment is high, it is easy to find replacement workers, and if most positions require a low-level skill set, we may be able to get away with paying less than average.

Highly successful companies like Google, Facebook, Starbucks, and Costco pay above average to hire the best, whereas most companies shoot for average, and companies like Walmart and McDonald’s with lower-skilled workers have historically paid below average compared to other industries but generally have to pay close to the same compensation as direct competitors to attract and retain employees.

A strong economy with high employment gives workers the incentive to seek better positions and higher pay. You may have heard that restaurant employees and other low-paid service workers continue to press for a minimum wage of $15 an hour, and some companies including Amazon are now paying that rate. But at the same time the higher wages give some companies like McDonald’s and Amazon the incentive to use technology/machines to replace employees who perform simple repetitive jobs.

What Types of Compensation?

We noted earlier in the chapter that we have four basic components to compensation—base pay, wage add-ons, incentives, and benefits. We need to determine how to divide the funds available between each of the components. (SHRM B:15)
Part IV • Compensating

There are some legal requirements for certain mandatory benefits such as Social Security, so these legal requirements have to be dealt with “off the top”—they have to be subtracted from the available funds. Once this is done, we need to determine how much direct compensation will be in the form of base pay and how much will be incentive pay.

Finally, we need to consider voluntary benefits. We need to analyze competition within the labor market and what benefits each of our close competitors provides because we will most likely have to approximately match the benefits that are provided by those competitors.44

Pay for Performance or Pay for Longevity?

In breaking down base pay versus incentives, we will need to look at whether our organization is going to have a performance philosophy or a longevity philosophy. Some companies pay people more for longevity or seniority, meaning accumulating years of service with the firm, by providing promotions and raises over time (assuming that we meet minimal organizational standards) regardless of performance because we have been a loyal member of the organization. Other companies, however, pay more for performance—for completing certain tasks or doing certain things faster or better than average, not just for being there and being loyal to the firm.45

Skill-Based or Competency-Based Pay?

If we decide to use skill-based or competency-based pay, we will pay members of the workforce for individual skills or competencies that they bring to work, whether or not those skills are necessary for the individuals to do their current job. Competencies involve the individual’s level of knowledge in a particular area, while skills involve the ability to apply that knowledge set in that field. Examples of competencies include such things as an understanding of negotiation and collaboration, or problem-solving and decision-making expertise. Examples of skills related to these competencies would include the ability to actually negotiate contract agreements, apply principles of physics to a new equipment design, or make a high-quality decision based on good analysis of a situation. With either method, we are paying our employees for knowledge, skills, and abilities that they may not necessarily ever use in the organization, so we have to ask whether it is valuable to have people with these extra skill sets.

Wage Compression

Another concern is wage compression. Wage compression occurs when new employees require higher starting pay than the historical norm, causing narrowing of the pay gap between experienced and new employees.46 We bring workers into the organization in both good economic times and bad. When the economy is doing poorly and wages are depressed, people will generally accept jobs for less than they would if the economy were doing well and higher-wage jobs were available. Since raises are frequently based on an employee’s initial salary or pay rate, those who start at lower pay than others may stay that way over time, and pay inequality for the same work may increase over time as well.

We may create a situation where workers with less time on the job might be paid nearly as much as, or more than (called wage inversion), employees who have worked for us for many years. This wage compression or inversion can weaken or destroy the desired link between pay and performance (expectancy theory), creating significant dissatisfaction on the part of long-term employees because of the pay differential.47 Most companies and organizations don’t set out to do this—they just fall into it.48 If we understand wage compression when creating a pay structure...
for the organization, we can avoid at least some of the dissatisfaction associated with the pay differentials between short-term and long-term employees.

**Pay Secrecy**

Recall our discussion of equity theory earlier in the chapter. One of the things some companies have historically done to avoid equity issues is demand *pay secrecy*, which means requiring employees to not disclose their pay to anyone else. But the National Labor Relations Board (NLRB) has consistently ruled that companies may not discipline workers who reveal information about their pay and other work conditions as long as the workers are participating in “protected, concerted activity,” and the NLRB views this activity very broadly. In addition, President Obama signed an Executive Order in 2014 (EO 13665) prohibiting pay secrecy policies in federal government contractors, with potential loss of government contracts as punishment for failure to comply. Several states in the United States have also passed laws specifically prohibiting pay secrecy policies. So, creating and enforcing pay secrecy clauses is becoming more dangerous to companies and is likely not worth the danger in today’s employment environment.

**Legal and Fairness Issues in Compensation**

>> **LO 10.4 Discuss the three major provisions of the Fair Labor Standards Act (FLSA).**

Several federal and state laws directly or indirectly affect pay and compensation systems. Virtually every equal employment opportunity (EEO) law identifies compensation as one of the employment actions where discrimination is prohibited if it is based on a protected characteristic. So we have to keep these laws in mind as we set up our pay system. See Exhibit 10.2 for a list of the major EEO laws and legal concepts that cover compensation.

**Fair Labor Standards Act of 1938 (Amended)**

Besides the Equal Pay Act and the other EEO laws, there are laws that deal with specific compensation issues. The grandfather of these laws is the Fair Labor Standards Act (FLSA). The major
provisions of the FLSA cover minimum wage, overtime issues, and child labor rules for most US-based businesses. Let’s complete a quick review of the FLSA. (SHRM B:6 and D:9)

Minimum Wage

The first major provision of the FLSA concerns the federal minimum wage. The minimum wage is the lowest hourly rate of pay generally permissible by federal law. The federal minimum wage in 2018 for most employees in the United States was $7.25 per hour. This is adjusted periodically by Congress, but the FLSA sets the minimum wage provision. Many states, and even cities, have set the minimum wage higher than the federal rate. You may have heard that Seattle, Washington, set the city’s minimum wage at $15 per hour, and several other large cities around the United States have now followed suit for at least some workers, including San Francisco and New York City. In addition, in 2014 Executive Order 13658 raised the minimum wage for federal contract workers, which stands at $10.60 per hour as of January 2019. So an HR manager needs to know, and keep up with changes to, the laws in their state and city.

Exempt or Nonexempt

Does everyone get paid at least the minimum wage for their area? Not exactly. There are some exemptions to the rules. If someone is exempt, by the definitions in the FLSA, they are exempt from the minimum wage requirement, overtime provisions, child labor rules, or possibly all three. People not meeting any of the requirements for an exemption are called nonexempt and must be paid minimum wage, overtime, and so forth.

As an example, workers who most people know are commonly exempt include restaurant servers. The current minimum wage for servers is $2.13 per hour. Servers normally expect to get a large portion of their wages in tips. The FLSA says we can pay tipped employees a minimum of $2.13 per hour as long as their tips make up the difference. So, if somebody in a restaurant works 20 hours in a week and does not make an average of $5.12 an hour in tips, it is illegal to pay that person $2.13. There are also other exemptions for individuals who are live-in child care providers, newspaper carriers, seasonal workers, among others. In fact, there are hundreds of exemptions. If you would like to review some of the exemptions in the FLSA, you can go to the Department of Labor website at http://www.dol.gov, and search for FLSA.

A set of quick guidelines can be used to determine exempt and nonexempt persons at work. If you make under $455 per week, or an annual salary of $23,660, you are pretty much guaranteed to be nonexempt under the provisions of the FLSA as of October 2018. “Highly compensated employees” paid $100,000 or more (and at least $455 per week) are pretty much automatically exempt from the minimum wage and overtime rules if they regularly perform at least one of the duties of an exempt executive, administrative employee, or professional employee identified in the standard tests for exemption. If an individual is paid more than $23,660 but less than $100,000, then the employee usually must meet a set of specific “duties tests” in order to fall within an exemption category (see Exhibit 10.3). There was a proposal by the Department of Labor to increase the minimum for exempt workers to approximately $970 per week, or around $50,000 annually, and the amount for highly compensated employees to roughly $122,000 per year, but the Department of Labor pulled the proposed regulation back for further work and comments. (SHRM B:1)

Overtime

Overtime is a higher than minimum, federally mandated wage, required for nonexempt employees if they work more than a certain number of hours in a week. Overtime is set by the FLSA as 150% of the individual’s normal wages for all hours in excess of 40 hours worked in a calendar week. With few exceptions, if a nonexempt employee works more than 40 hours in a week, that employee is eligible for overtime. (SHRM 1:1-c)

Contrary to what many people think, the FLSA has no requirement for paying anything more than time-and-a-half for any overtime work. Employers are also not required to provide paid holidays, vacation, or extra pay for working on weekends or on holidays under federal law, although many states now have rules covering these situations.
### EXHIBIT 10.3  Duties Tests for General Employee Exemptions

#### Executive Exemption
To qualify for the executive employee exemption, the employee must meet all of the following criteria:

- The employee must be compensated on a salary basis (as defined in the regulations) at a rate of not less than $455 per week;
- The employee’s primary duty must be managing the enterprise or managing a customarily recognized department or subdivision of the enterprise;
- The employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent; and
- The employee must have the authority to hire or fire other employees; or the employee’s suggestions and recommendations as to the hiring, firing, advancement, promotion, or any other change of status of other employees must be given particular weight.

#### Professional Exemption—Learned or Creative
To qualify for the learned professional employee exemption, the employee must meet all of the following criteria:

- The employee must be compensated on a salary or fee basis (as defined in the regulations) at a rate not less than $455 per week;
- The employee’s primary duty must be the performance of work requiring advanced knowledge, defined as work that is predominantly intellectual in character and that requires the consistent exercise of discretion and judgment;
- The employee’s advanced knowledge must be in a field of science or learning; and
- The employee’s advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.

To qualify for the creative professional employee exemption, the employee must meet all of the following criteria:

- The employee must be compensated on a salary or fee basis (as defined in the regulations) at a rate not less than $455 per week;
- The employee’s primary duty must be the performance of work requiring invention, imagination, originality, or talent in a recognized field of artistic or creative endeavor.

#### Administrative Exemption
To qualify for the administrative employee exemption, the employee must meet all of the following criteria:

- The employee must be compensated on a salary or fee basis (as defined in the regulations) at a rate not less than $455 per week;
- The employee’s primary duty must be the performance of office or nonmanual work directly related to the management or general business operations of the employer or the employer’s customers; and
- The employee’s primary duties must include the exercise of discretion and independent judgment with respect to matters of significance.

#### Outside Sales Exemption
To qualify for the outside sales employee exemption, the employee must meet all of the following criteria:

- The employee’s primary duty must be making sales (as defined in the FLSA) or obtaining orders or contracts for services or for the use of facilities for which a consideration will be paid by the client or customer; and
- The employee must be customarily and regularly engaged away from the employer’s place or places of business.
- The salary requirements of the regulation do not apply to the outside sales exemption.

#### Computer Employee Exemption
To qualify for the computer employee exemption, the employee must meet all of the following criteria:

- The employee must be compensated either on a salary or fee basis at a rate of not less than $455 per week or, if compensated on an hourly basis, at a rate of not less than $27.63 an hour;
Part IV • Compensating

EXHIBIT 10.3 ● (Continued)

Computer Employee Exemption

- The employee must be employed as a computer systems analyst, computer programmer, software engineer, or other similarly skilled worker in the computer field performing the duties described in the next bullet point;

- The employee’s primary duty must consist of one of the following:

  1. The application of systems analysis techniques and procedures, including consulting with users to determine hardware, software, or system functional specifications;

  2. The design, development, documentation, analysis, creation, testing, or modification of computer systems or programs (including prototypes), based on and related to user or system design specifications;

  3. The design, documentation, testing, creation, or modification of computer programs related to machine operating systems; or

  4. A combination of the aforementioned duties, the performance of which requires the same level of skills.


10.2 APPLYING THE CONCEPT

EMPLOYEE EXEMPTIONS

Identify each job as generally being considered exempt or not from minimum wage or overtime pay (write a or b before each job type).

a. Exempt

b. Nonexempt

6. Auto mechanic

7. Fruit picker

8. Worker on a foreign-flag cruise ship

9. Librarian

10. Taxi driver

11. Real estate agent

12. Bellperson at a hotel

13. Computer programmer (paid more than $27.63 per hour)

14. Hairdresser

15. Bank teller

Child Labor

The FLSA also has rules on the use of child labor, meaning workers under 18 years old. If individuals are 18 or older, we can use them in any normal employment situation. However, we can employ 16- and 17-year-olds only in nonhazardous jobs, although their work hours are unrestricted, and there are significantly different rules for 14- and 15-year-olds.

Minors age 14 and 15 may work outside school hours for no more than “three hours on a school day, 18 hours in a school week, eight hours on a nonschool day, and 40 hours in a nonschool week.” They can’t start work before 7:00 a.m. or work after 7:00 p.m., except from June 1 through Labor Day, when they can work until 9:00 p.m. Jobs they can work are limited to retail, food service, and gasoline service at establishments specifically listed in the FLSA regulations. Employees 14 and 15 years old may not work overtime. While there are some exceptions to these rules for businesses such as family businesses or family farms, these are the general guidelines for child labor.

Employee Misclassification Under the FLSA

Misclassification of employees as exempt from minimum wage or overtime is one of the most common areas where companies get into serious trouble. Just paying an employee a “salary” and then working that person for unlimited hours is obviously illegal under the general exemption FLSA rules listed in Exhibit 10.3.
So why does misclassification occur? Obviously, companies want to save money. Many employers think that if they put you on salary, they don’t have to pay overtime—so they put you on a salary and work you 70 hours per week. Another company might say, “All my people are professionals, so they are all exempt.” But this is rarely possible in reality, if you look at the FLSA rules for exemption. Breaking FLSA law can result in costly civil penalties, and repeated offenses can even land you in jail.

Pay Equity and Comparable Worth

One of the more controversial issues in compensation is comparable worth. **Comparable worth** is the principle that when jobs are distinctly different but entail similar levels of ability, responsibility, skills, and working conditions, they are of equal value and should have the same pay scale. According to the U.S. Census Agency, women earn an average of about 80 cents for every dollar that men earn.\(^5\) This is one of the major reasons that comparable worth continues to be an issue in both business and government. While equal pay for equal work is the law (EPA of 1963), comparable worth is not currently federal law except in some very limited cases. (SHRM B:17 and I:1-b)

Comparable worth is simply “similar pay for similar work.” Although this sounds almost like the equal pay for equal work stipulated by the Equal Pay Act, the doctrine of comparable worth says that if we can compare your job with that of another person, and if the two jobs are similar but not the same, then we should pay you a similar wage but not necessarily exactly the same wage. So this concept is much broader than equal pay.

As we noted, though, there are a few exceptions where comparable worth is law. A number of states—with California in the lead—have passed fair pay laws that are designed to require comparable pay in at least most work environments and that shift to the employer the burden of showing that any pay differences are due to valid, legal reasons.\(^6\) But in most cases these laws have not passed yet, at least partially because of the market value factor for jobs. Let’s face the facts that measurement, reliability, and validity issues exist. It is very difficult to compare a factory job to an office job. And as discussed, many companies are working to get more women and minorities into better paying jobs rather than trying to figure comparable worth.

Other Legal Issues

A number of other federal laws place controls on pay and benefits. Recall from Chapter 9 that the National Labor Relations Act (NLRA) allows collective bargaining on the part of workers who join a union. Since the NLRA allows employees to bargain collectively with their employers for wages, benefits, and working conditions, in limited cases the workers can agree to a workweek that is longer than 40 hours. The wages paid must be significantly higher than the minimum wage, and other conditions apply, but it is possible for the collective bargaining unit to agree to more than a 40-hour workweek.\(^7\) Some union contracts also require mandatory overtime with pay. (SHRM B:11 and B:24)

Mandatory employee pension and benefits legislation affecting overall compensation also includes the following:

- Social Security
- Workers’ compensation
- Unemployment insurance
- Family and Medical Leave Act (FMLA)
- Patient Protection and Affordable Care Act (ACA)
• Employee Retirement Income Security Act (ERISA—mandatory for employers who offer pension plans)
• Health Insurance Portability and Accountability Act (HIPAA—mandatory for employers who offer health insurance)

We will discuss each of these laws further in Chapter 11.

**Job Evaluation**

>> **LO 10.5 Name the three types of job evaluations by describing whether they are more objective or subjective in form.**

Deciding how much each job is worth in a company is difficult. There are two approaches to this—internal and external—though they may be used together. First we discuss the external method, followed by three internal methods. *(SHRM B:12)*

**External Versus Internal Methods**

An *external approach* involves finding out what other organizations pay for the same or similar jobs through available pay surveys, and setting pay levels based on market pricing. In a recent survey, about 95% of companies said they use at least one source of pay survey data or other external information to determine market pricing for their jobs. On the other hand, an *internal approach* uses job evaluation. *Job evaluation* is the process of determining the worth of each position relative to the other positions within the organization. Organizations commonly group jobs into pay levels or grades, and the higher the grade of the job, the higher the pay. A common example of this type of grouping is the federal government’s general schedule (GS) ratings. *(SHRM I:3 and B:21)*

How do we accomplish a job evaluation? There are several ways, but methods usually involve ranking jobs, or assigning points to activities that occur within a job and totaling the points for the job. Once this is done, we can place the job in a hierarchy, called a *job structure*, and create our pay grades.

**Job Ranking Method**

*Job ranking* is simply the process of putting jobs in order from lowest to highest, in terms of value to the company. When doing job ranking, we utilize the job descriptions we discussed in Chapter 4 to identify the factors in each job and then rank those jobs based on their content and complexity. We usually do job ranking without assigning points to different jobs. So we might start at the top of the organization with the CEO as the highest-ranking person and then work all the way down to the lowest-skilled housekeeping job.

But if you look at this method for a second, you will see that somebody has to decide the value of each job and do so without any quantitative factors. Therefore, this determination requires judgment and is highly subjective. This means it is difficult to defend if we have to do so in court.

**Point-Factor Method**

A second type of job evaluation is the point-factor method, which attempts to be completely objective in form. This method breaks a job down into components like particular skills or abilities and then assigns a number of points to each component based on its difficulty. These components are usually referred to as *compensable factors*. *(SHRM B:9)*

Many of the compensable factors will be common among a number of different jobs, so once we have identified the number of points the factor is worth, we can then transfer that same value to all other jobs where the factor is present. The value of the point-factor job evaluation method is that we can differentiate jobs based on the difficulty or intensity of each factor, so it becomes easier to determine the total value of the job in a quantitative form.
Factor Comparison Method

The factor comparison method combines the job ranking and point-factor methods to provide a more thorough form of job evaluation. This model is somewhat similar to the point-factor method in that it assigns points to compensable factors. However, the factor comparison method first identifies a group of benchmark jobs—positions that are identified and evaluated in a large number of organizations and that can generally be found in most pay surveys.

Examples of benchmark jobs include “Training Specialist I,” “Accountant II,” “Lending Officer I,” and “Hotel Registration Clerk.” These benchmark jobs are then analyzed in some detail based on their compensable factors. We then rank the benchmark jobs in order, and we finally compare all other jobs in the organization to the benchmark jobs to determine where each one fits in the rankings. Here again, the primary method of determining the monetary value of a job is through the analysis of the compensable factors.

10.1 ETHICAL DILEMMA: WHAT WOULD YOU DO?

EXECUTIVE COMPENSATION

In 2017, the CEO-to-worker pay ratio was about 361:1. Oracle’s co-CEOs made about $25.3 million each in 2018. A minimum wage full-time employee at Walmart would have to work more than 1,500 hours to earn as much as the Walmart CEO makes in 1 hour. Some say top executives are being overpaid; Fortune 500 CEOs all make millions.

However, not everyone agrees. In capitalist countries, talented CEOs, like in pro sports, are entitled to fetch their price. Top executives should be paid multimillion-dollar compensation packages; after all, if it weren’t for effective CEOs, companies would not be making the millions of dollars of profits they make each year. CEOs deserve a piece of the pie they help create.

1. Do executives deserve to make 300 times more than the average worker?
2. Is it ethical for managers to take large pay increases when laying off employees?
3. Is it ethical for managers to get pay raises when their companies lose money?
4. Are companies being socially responsible when paying executives premium compensation?


10.3 APPLYING THE CONCEPT

JOB EVALUATION

Review the list of job evaluation methods and then write the letter corresponding to each method before each statement below.

a. External
b. Job ranking
c. Point-factor
d. Factor comparison

16. I use two methods together to determine how much to pay each position because I’m an HR professional.

17. I look at the job and determine the specific skills needed to do the job, and then I add up the total point value of the skills to set the pay.

18. To figure out how much to pay the data entry person, I’m checking the SHRM data.

19. I placed all the jobs in rank order, from the one that was worth the most to the one that was worth the least, in order to determine how much to pay for each position.

20. All of the companies in our industry pay essentially the same hourly wage.
Developing a Pay System

LO 10.6 Briefly describe the concept of job structure, pay levels, product market competition, and labor market competition.

10.7 Briefly describe the concept of a pay structure, including broadening and delayering.

Well, we have finally gotten to the point where we can start to develop our pay structure. Remember, though, all of the things that we had to review and decide on first. Take a look now at Exhibit 10.4 to see how each of those items comes together to allow us to create a pay structure and individual pay rates for each job. (SHRM B:3)

EXHIBIT 10.4  Creation of a Pay Structure and Individual Pay Rates

Job Structure and Pay Levels

A pay structure is a hierarchy of jobs and their rates of pay within the organization. It allows us to identify what the pay range is for each job. Once we have completed the process of creating a pay structure, we will have the pay range for every job in the hierarchy. From that, managers can determine individual compensation levels based on the employee’s performance, seniority, skills, and any other significant factors.

A pay structure is composed of both a job structure and pay levels. The job structure is what gives us our job hierarchy. As we noted in the job evaluation section of this chapter, the job structure is the stacking up of the jobs in the organization, from the lowest to the highest level. Each of the jobs within the job structure will end up at a particular pay level. On the other hand, a pay level (frequently called a pay grade) can be made up of many different jobs, and each pay level has a maximum pay rate and a minimum pay rate. (SHRM B:18)
Creation of Pay Levels

To establish pay levels and determine the maximum and minimum pay rates for particular jobs, we will have to look at some market factors. We look at product market competition and labor market competition because if we don’t pay attention to external equity or fairness, we are going to have trouble filling many of our jobs. (SHRM B:4)

Product Market Competition and Labor Market Competition

To set the minimum value for a particular pay level, we have to look at the applicable labor market competition, meaning labor supply versus demand for labor. If we graph compensation for a given type of work versus the number of workers in the labor market who can do that type of work, the place where the two lines cross is the average pay for that work. As shown in Exhibit 10.5, when the supply of labor equals the demand for that labor in the workforce, we have equilibrium. The market will pay close to what the workers demand to be paid, or workers who have the necessary skills won’t be willing to fill the job. (SHRM B:10 and B:13)

What happens in bad economic times, when there are more workers available than jobs? The market can get some of them to work for less than the normal rate (where the lines cross in Exhibit 10.5) because those workers need to work and earn a living. So the average compensation will most likely go down because we will have an oversupply situation. Conversely, if we have more jobs available than we have workers, we will usually have to pay more to attract the limited number of workers with the skill sets that we require. In either case, labor market competition will set the minimum pay that a worker will require in order to come to work for us—but it can be a moving target that we have to track.

On the other hand, how do we determine the top of the pay level? We have to look at something called product market competition. This is basically a function of the value of the product or service that we sell to the customer. An example will help make it clear. Let’s say we manufacture utility trailers (see Exhibit 10.6). The public will pay about $500 for our 5- by 8-foot utility trailers. To make the problem simple, we will pretend that we only have a couple of components that go into making that trailer: labor and materials. Let’s assume that all of the materials are going to cost $250.

What do we have left for labor? Do we have $250? No! We also have some other indirect costs like overhead, don’t we? And we would like to make a profit, right? So if we estimate all of our other costs at $50, we now have $200 left. We can pay labor $200 if we only want to break even. However, if we want to make any money, we have to pay less than $200 for labor. Assume that our person who makes the trailer makes $20 per hour and it takes that person 8 hours to build a trailer—$160 for the 8 hours of labor costs. So we have a $40 profit left, or about 8% before-tax profit.

EXHIBIT 10.5 ● Supply and Demand Curve

![Diagram of Supply and Demand Curve]

More workers than jobs = Lower pay

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Part IV • Compensating

EXHIBIT 10.6 • Product Market Competition Limits

Utility Trailer Manufacturing

$500 Sale price

$-250 Material costs

$250 = Remainder

- $50 Overhead costs

$200 = Remainder

$-160 Labor (maximum cost of labor)

$40 = Before-tax profit (8%)

Your assembler comes to you and says, “Boss, I need a raise.” What do you just about have to tell the employee? “We can’t pay you more.” If our trailer is priced at $800 and a competitor’s trailer is $500, almost everyone will buy the competitor’s trailer. We can’t charge much more than the normal rate for a product or service. The labor is only worth so much money, because the sale price of the good or service has to cover the cost of the labor. So, product market competition sets the top of the pay level for most types of jobs in the company.

Exhibit 10.7, then, shows that we have a maximum and a minimum level of pay for a particular class of jobs, with labor market competition setting the bottom of the range and product market competition setting the top of the range. Remember, though, that this is a simplified example—there may be other factors involved as well.

EXHIBIT 10.7 • Pay Levels

Product Market Competition

Midrange

Labor Market Competition

Benchmark Job

Benchmarking Pay Survey Data

Next, we look at benchmarks from the pay survey data that we reviewed earlier and put those benchmark jobs into the pay level where they belong (the blue dots in Exhibit 10.7). Once we place some benchmark jobs in a plot of our pay levels, we can get a market pay line (sometimes called a pay curve)—a line that shows the average pay for various jobs at different levels in a particular industry (see Exhibit 10.8). We use the benchmarks to see whether or not what we are doing is OK. If the range is correct, we have successfully created a pay level; if not, we have to figure out what is wrong with our range. (SHRM K:3 and B:20)

After going through this process for a particular pay level, we end up with a rate range, which provides the maximum, minimum, and midpoint of pay for a certain group of jobs. Once the range is created, we can go in and add to the range any other jobs that are at approximately the same level based on our earlier job evaluations.

Rate range The maximum, minimum, and midpoint of pay for a certain group of jobs

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Pay Structure

So we have figured out our first pay level. What do we do now? We start to lay pay levels out next to each other, creating a pay dispersion.\(^7\) Again, look at Exhibit 10.8. We take our first pay level and put it down: bottom, midpoint, and top. The bottom of the range for the first level will probably be near minimum wage in most cases. Then our second tier will start, and beyond that will be the third and the fourth, and so on.

Notice that the ranges overlap each other. Why do they overlap? Take a look at the market pay line. It would have to go exactly through the corners of each pay level if the levels didn’t overlap. That doesn’t give us much wiggle room on which to base people’s pay rates, does it? So the major reason for the overlap is to give the company some flexibility in each person’s pay within a particular pay level.

Once we set up our pay levels, we can plot the actual pay for people in the organization. These are indicated in Exhibit 10.8 as black dots. We identify where these actual pay levels fall within the pay structure, and we will sometimes see that we have someone plotted outside our pay level ranges—either too high or too low. Individual pay rates that fall outside the pay range on the high side are called red-circle rates (red dots in Exhibit 10.8), and those that are lower than the bottom of the pay range are green-circle rates (green dots in Exhibit 10.8). If we find a green-circle rate for an individual, the correct thing to do is to raise the individual’s pay to at least the minimum for that pay level, because we are not paying them fairly for their skill set.\(^2\)

But what should we do about a red-circle rate? We probably won’t cut someone’s pay, but we will not be able to pay them any more unless they move up to a higher skill level, and therefore
Part IV  •  Compensating

A higher pay level. For instance, if our assembler is making $24 per hour, the maximum for his pay level is $20, but he wants a pay raise and hasn’t had one in several years, we will have to tell him no. However, we can also tell him that if he is willing to become a supervisor, he can get the chance to raise his pay rate because the skill level for a supervisor is higher than that of an assembler. (SHRM B:2)

Understanding pay levels and pay structure allows us to provide good answers to employees about why their pay is set at a certain level. If a worker decides to become a supervisor, that employee is worth more and we can pay more. So we are able to tell the employee, “The job isn’t worth any more than what you are being paid,” instead of saying, “You are not worth any more than that.”

Delayering and Broadbanding

A trend for many years now has been to lower the number of pay levels using one of two options—either delayering or broadbanding. Delayering is the process of changing the company structure to get rid of some of the vertical hierarchy (reporting levels) in an organization. On the other hand, broadbanding is accomplished by combining multiple pay levels into one. When we lower the number of pay levels that we have to deal with, managing the pay process is simpler. It takes a long time to create, maintain, and evaluate 20 pay levels, when instead we can have just 5 broadbands. It also allows more capacity to reward outstanding performers. Because we have taller and wider levels, there is more pay flexibility while staying within the boundaries of the pay level.
Take a look at what happens to the pay structure in Exhibit 10.9 when we convert it into a broadband pay structure. The new broadband pay structure combines the first two pay levels, the third and fourth level, and finally the fifth and sixth, making three levels instead of six. This causes our red- and green-circle rates to disappear. It also creates greater ability to adjust the pay of people based on their performance and ability. Finally, it lowers the administrative burden of maintaining the compensation system.

So when we are done with the pay structure, we will have created that hierarchy of jobs that we mentioned earlier—from lowest to highest. And as you have probably already guessed, much of this work is now done using computers. Once the human resources management system (HRMS) has the necessary data, we can create most of our pay structure using existing company information. In many cases, the HRMS can identify the market pay line and provide other compensation information, too.

We should realize that developing a pay system is not a one-time task. Achieving pay equity requires monitoring and addressing pay as you hire, promote, and try to retain key employees. Most large companies don’t start from scratch or make huge overhauls, they do things little by little to see how the changes are working. Thus, compensation management is an important function within HR management. As we bring this chapter to a close, complete the self-assessment to determine your compensation management satisfaction.

### 10.1 SELF-ASSESSMENT

#### COMPENSATION MANAGEMENT SATISFACTION

This exercise is also a good review of the chapter, as it uses most of the important concepts discussed in this chapter. Select an organization that you work for, or have worked for, and select your level of satisfaction with each of the following parts of the compensation management system, on a scale of 1 to 5.

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1. Base pay
2. Wage and salary add-ons
3. Incentive pay
4. Benefits
5. Meeting expectancy theory
6. Meeting equity theory
7. What the firm actually pays based on its ability to pay
8. Pay for performance vs. longevity
9. What the firm pays based on being below, at, or above market-level pay
10. Wage compression
11. Pay secrecy
12. Meeting the Fair Labor Standards Act
13. Pay equity and comparable worth
14. The system used for job evaluation
15. Job structure
16. Pay levels
17. Benchmarking
18. Pay structure
19. Pay raises
20. Benefit increases

Total the points and place the score on the continuum below.

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The higher the score, the greater your level of satisfaction with the compensation management system of the organization. However, to most employees, what really matters most is answers to questions regarding their own pay and benefits (compensation), and we all are more satisfied when these increase.

Think about the people you worked with as a group. You can select the group’s level of satisfaction with each question. Would their answers vary from yours? Would the satisfaction level vary by the level in the organization—among executives versus nonmanagers, by department, or among other groupings?
Trends and Issues in HRM

What trends are we seeing in the compensation of our current workforce? One trend is more independent contractors working with companies over the long term. Second, we look at that continuing stubborn gender wage gap.

Designation of Independent Contractors Continues to Be an Issue

More on-demand workers, more independent contractor relationships, and fewer employer-employee relationships is the new normal. Why are companies moving toward these independent contractor relationships? One reason is to maximize organizational flexibility. In many cases, the relationship with independent contractors can be severed much more easily than those with employees. If there is no long-term contract, the company can release the contractor immediately on completion of whatever job is currently being done. Another reason for this type of arms-length relationship is that it can save the company from significant costs. Compensation of an independent contractor is much simpler than compensation of employees. In the contract relationship, the company pays the agreed-upon amount on the contract, and there is no need to calculate hours, minimum wage, overtime, benefits costs, health care insurance eligibility, or any other compensation factors. They also do not have to pay federal (social security and other) taxes or state mandated (unemployment, workers’ compensation, etc.) taxes among other costs. All of those requirements fall to the contractor to manage.

Employers may think it is easy to make an employee into a contractor, but independent contractors must be truly independent of the company’s control. According to the IRS website, “The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done.” The U.S. Supreme Court identified a “total activity” test to help determine whether or not a case is dealing with an employer-employee relationship:

1. The extent to which the services rendered are an integral part of the principal’s business
2. The permanency of the relationship
3. The amount of the alleged contractor’s investment in facilities and equipment
4. The nature and degree of control by the principal
5. The alleged contractor’s opportunities for profit and loss
6. The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor
7. The degree of independent business organization and operation

Uber and the federal government disagree concerning whether or not Uber drivers are independent contractors. In one case, a federal judge rejected a proposed settlement for $100 million because the deal “undervalued” potential claims. However, several other federal judges have ruled that Uber drivers are not employees. Employers need to be aware of, and concerned with, their use of such identifications, because of the current confused nature of the rulings. Intentionally misclassifying employees as contractors is also very dangerous to the company. It is unethical and illegal to intentionally misclassify individuals to avoid paying them what would reasonably and ordinarily be due them in their relationship with the company, and it carries the same penalties as other FLSA violations should the employer get caught.

The Stubborn Gender Wage Gap—Can It Be Fixed?

According to Fortune magazine, “Gender parity in wages still has a long way to go.” Research backs this up. Sex differences in total rewards in the workplace were 14 times larger than sex differences in performance evaluations according to one study, and even though the pay gap
is likely the smallest it has been since about 1960, evidence still shows that women make only 80% of what men do on average across all industries in the United States. Why is this wage gap so stubborn?

Some of the gap can be explained away based on a number of factors other than discrimination. For instance, it is true that women leave the workforce more often than men and that women tend to be absent more when employed compared with their male counterparts. There are logical reasons for these facts, including the fact that women tend to still be the primary caregiver to children in a family, but they are still fact. However, at least some of the difference appears to still be an inherent bias toward male employees. Some states have passed laws that limit the ability for companies to exhibit such biases, and companies are taking notice. According to HR Magazine, “Pay equity has become a top-of-mind concern for employers nationally as a result of California’s new gender pay equity law and similar legislation in New York and elsewhere.” Pay equity is not just a U.S. issue either. Countries as varied as Iceland, New Zealand, and Singapore are discussing the issue and passing gender equity laws. But not enough seems to be getting done.

So what can be done? Government rulemaking can only go so far. In some cases, it appears there has been some overreach on the part of federal—and maybe state—agencies, which will probably not help the situation either. Google pushed back when the Department of Labor demanded information that the company claimed would cost more than $1 million to gather on a contract that only paid them $600,000. But good companies, including Google, say they want to do something to minimize the gap. The monitoring of the problem and enforcement of solutions will almost always fall to HR. Leaders can maintain records of initial salary negotiations and ultimately of offers, manage and evaluate any compensation increases over time, and complete pay audits on a periodic basis. If unexplainable disparities are found during the various analysis efforts, HR needs to make recommendations to senior management to correct any problems by adjusting compensation components as needed. Pay disparity is a fact. Consistent vigilance is the only way to combat this stubborn issue.

**Chapter Summary**

**10.1 Identify the components of a compensation system.**

Components of compensation include the following four items:

1. **Base pay, either an hourly wage or salary.** Base pay is frequently a major decision factor for most employees in deciding to accept the job.
2. **Wage and salary add-ons.** These include overtime pay, shift differential, premium pay for working weekends and holidays, and other add-ons.
3. **Incentive pay for performance.** Incentives give workers strong reasons to perform above the standard.
4. **Benefits.** This provides something of value to the employee. Benefits cost the company money even though they aren’t direct compensation.

**10.2 Describe how expectancy and equity theories apply to compensation.**

Expectancy theory (Motivation = Expectancy × Instrumentality × Valence) says that employees expect to put forth some form of effort at work and believe they can accomplish the task or objective (expectancy). This effort is expected to result in some level of performance resulting in some type of reward (instrumentality). The reward has to be significant (valence) to the individual, and as long as it is, the employee will continue to put out effort to get the reward.

In equity theory, people compare their inputs (the things they do in the organization) and outcomes (the things that they receive from the organization) to those of relevant others. But it’s their and others’ perceived inputs and outcomes that employees compare, not necessarily actual inputs and outcomes. If employees believe that there is inequity, they will change their work behavior to create equity.
10.3 Identify the seven basic issues that make up the organizational compensation strategy.

1. **Ability to pay.** This is an honest assessment of how much we can afford, or are willing to afford, in order to compensate our employees.

2. **At, above, or below the market.** What will our general pay structure look like, and why?

3. **Types of compensation.** This refers to the mix of the four basic components of compensation—base pay, wage add-ons, incentives, and benefits—that we employ. We must divide available funds among the components.

4. **Pay for performance or longevity.** Will we pay people based on organizational loyalty/tenure, or will we pay based on performance in their jobs?

5. **Skill or competency-based pay.** Competencies involve the individual’s level of knowledge in a particular area, while skills involve the ability to apply that knowledge set.

6. **Wage compression.** This lowers the pay differential between long-term and newly hired employees.

7. **Pay secrecy.** Will we utilize pay secrecy clauses in employment contracts? Pay secrecy may allow us to hide actual wage inequities from employees, but it has the potential to create dissatisfaction and demotivation.

10.5 Name the three types of job evaluations by describing whether they are more objective or subjective in form.

1. The job ranking method is simply the process of putting jobs in order from lowest to highest or vice versa, in terms of value to the company. However, it has limited usefulness because it is subjective.

2. The point-factor method attempts to be completely objective in form. It breaks a job down into component skills or abilities, known as factors, and then applies points to each factor based on its difficulty.

3. The factor comparison method combines the ranking and point-factor methods to provide a more thorough form of job evaluation. It identifies benchmark jobs and then analyzes and rank-orders them. We then compare all other jobs in the organization to the benchmark jobs to determine where each one fits in the rankings.

10.6 Briefly describe the concepts of job structure, pay levels, product market competition, and labor market competition.

- **Job structure** is what gives us a job hierarchy. The **job hierarchy** is the stacking of the jobs in the organization from the lowest (simplest) to the highest (most complex) levels.

- A **pay level** (frequently called a pay grade) will be made up of several different jobs. Pay levels provide a framework for the minimum and maximum pay for a particular group of jobs in the organization. Pay levels are then laid out one next to another in order to create the entire pay structure for the company.

- **Product market competition** sets the top of a pay level. We can only pay someone as much as we can recover from a customer when we sell our goods or services. We can’t pay more than the value added to the product or service by the labor. Together, product market and labor market competition identify the maximum and minimum rates of pay for a particular group of jobs in a pay level.

- **Labor market competition** sets the bottom of a pay level. We have to compete with other companies to attract labor, and if we don’t pay enough, we will be unable to attract the workers we need. So we compete in the labor market for available workers.
10.7 Briefly describe the concept of a pay structure, including broadbanding and delayering.

A pay structure is created by laying out our pay levels, one next to the other. The entire group of pay levels creates the pay structure. Benchmark jobs can be plotted on the pay structure to get a market pay line—a line that shows the average pay at different levels in a particular industry. Once pay levels are set, we can actually plot employee rates of pay on the pay structure to see if any are plotted outside our pay level ranges, either high or low. Individuals who fall outside our pay range to the high side are paid red-circle rates, and those who fall outside low are paid green-circle rates. Each of these rates should be reviewed and corrected if necessary.

**Key Terms**

- broadbanding, 270
- compensation, 254
- compensation system, 254
- delayering, 270
- equity theory, 256
- expectancy theory, 255
- job evaluation, 264
- minimum wage, 260
- overtime, 260
- pay structure, 266
- rate range, 268
- wage compression, 258

**Key Terms Review**

Complete each of the following statements using one of this chapter’s key terms.

1. _____ is the total of an employee’s pay and benefits.
2. _____ includes anything that an employee may value and desire and that the employer is willing and able to offer in exchange.
3. _____ proposes that employees are motivated when they believe they can accomplish a task and the rewards for doing so are worth the effort.
4. _____ proposes that employees are motivated when the ratio of their perceived outcomes to inputs is at least roughly equal to that of other referent individuals.
5. _____ occurs when new employees require higher starting pay than the historical norm, causing narrowing of the pay gap between experienced and new employees.
6. _____ is the lowest hourly rate of pay generally permissible by federal law.
7. _____ is a higher than minimum, federally mandated wage, required for nonexempt employees if they work more than a certain number of hours in a week.
8. _____ is the process of determining the worth of each position relative to the other positions within the organization.
9. _____ is a hierarchy of jobs and their rates of pay within the organization.
10. _____ provides the maximum, minimum, and midpoint of pay for a certain group of jobs.
11. _____ is the process of changing the company structure to get rid of some of the vertical hierarchy (reporting levels) in an organization.
12. _____ is accomplished by combining multiple pay levels into one.
Communication Skills

The following critical-thinking questions can be used for class discussion and/or for written assignments to develop communication skills. Be sure to give complete explanations for all answers.

1. Do you believe it is always necessary to provide incentives as part of a pay structure? Why or why not?
2. As the HR manager, would you pay more attention to expectancy theory or equity theory in designing your compensation system? Why?
3. If your company had promised an incentive program right before the recession of 2007–2008, and if the recession made it impossible for the company to pay employees what they had been promised, then how would you explain this to your workforce to keep them motivated?
4. Would you rather have higher pay or better benefits? Why?
5. Would you ever consider paying below the market rate for employees if you had control of wages? Why or why not?
6. How would you approach a CEO or company president who insisted on classifying nonexempt workers as exempt? What would you say to get the CEO to stop this practice?
7. Do you think that comparable worth should be made federal law? Why or why not?
8. If you were the lead HR manager in your company, would you ever consider setting pay levels by just using external pay surveys and no internal analysis? What are the advantages and disadvantages of this?
9. As the head of HR, would you rather change narrow pay levels into broadbands? Can you think of any disadvantages to doing so?

Case 10.1 Discounting Everything but Compensation at Costco

Only Costco as a physical retailer can go toe-to-toe with Walmart in the wholesale market and come out on top. Operating more than 715 membership warehouse stores, Costco is the nation’s largest wholesale club operator (ahead of Walmart’s Sam’s Club). Primarily under the Costco Wholesale banner, it serves more than 71 million members in 44 U.S. states, Washington, D.C., and Puerto Rico, as well as in Canada, Mexico, the United Kingdom, Japan, South Korea, Taiwan, and Spain. Stores offer discount prices on an average of about 3,700 products (many in bulk packaging), ranging from alcoholic beverages and appliances to fresh food, pharmaceuticals, and tires. Certain club memberships also offer products and services, such as car and home insurance, mortgage and real estate services, and travel packages.87

How can Costco beat other retailers, such as Walmart, BJ’s, and Target, who sell similar products and services? By looking for ambitious, energetic employees who enjoy a fast-paced team environment filled with challenges and opportunities. Their successful employees are service-oriented people with integrity and commitment toward a common goal of excellence. More important, Costco offers, in their own words, “great jobs, great pay, great benefits and a great place to work.”88

Their benefits package not only provides their employees with a full spectrum of benefits (medical, dental, pharmacy, vision, 401K matching, short- and long-term disability, life insurance, and others), but employees also may elect coverage for their spouses, children, and domestic partners. The company pays a larger percentage of the premiums than do most other retailers, and employee-paid premiums are withheld pre-tax, which means employees get to keep more of their hard-earned money.

U.S. BENEFIT-ELIGIBILITY REQUIREMENTS ARE AS FOLLOWS:

- **Hourly employees** (full-time) are benefit-eligible on the first of the month after working 450 hours or 90 days, whichever comes first.
- **Hourly employees** (part-time) are benefit-eligible on the first of the month after working 600 hours or 180 days, whichever comes first.
- **Salaried employees** are benefit-eligible on the first of the month after date of hire.

HEALTH CARE

Full-time and part-time benefit-eligible Costco employees are offered generous health care coverage with low biweekly payroll contributions.
DENTAL CARE

Full-time benefit-eligible Costco employees may choose from two different dental plans: a core dental plan and a premium dental plan. Part-time benefit-eligible employees may elect a core dental plan.

PHARMACY PROGRAM

Most Costco warehouses have pharmacies in-house, making it easy to pick up prescriptions at work. Benefit-eligible employees’ co-payments can be as little as $3 for generic medications, and a 15% co-pay applies to other types of medications.

VISION PROGRAM

Most Costco warehouses have in-house optical centers, which make it easy to access this benefit. For benefit-eligible employees and covered dependents, the program pays up to $60 toward a refraction eye exam and $175 for the purchase of prescription glasses and contact lenses.

401K PLAN

Costco matches employee contributions 50 cents on the dollar for the first $1,000 each year to a maximum company match of $500 a year ($250 a year for West Coast Union employees).

DEPENDENT CARE ASSISTANCE PLAN

This allows you to pay for day care for children under age 13, as well as adult day care, with pre-tax dollars.

CARE NETWORK

Care Network’s professional counselors are dedicated to Costco employees and trained to help resolve personal, work, or family challenges. They also can provide guidance, information, and/or referrals to local service providers, including lawyers, debt resolution services, and behavioral health professionals.

VOLUNTARY SHORT-TERM DISABILITY

Where disability coverage isn’t mandated by their state, all hourly employees who pass their 90-day probationary period and are working at least 10 hours a week will be automatically enrolled in short-term disability insurance.

LONG-TERM DISABILITY

Coverage is at no cost for benefit-eligible employees who are enrolled in a medical plan. This policy pays up to 60% of their earnings if they are out past 180 days.

LIFE INSURANCE

Benefit-eligible employees enrolled in a medical plan also receive basic life insurance and accidental death and dismemberment policies provided at no cost.

EMPLOYEE STOCK PURCHASE PLAN

New employees are immediately eligible to enroll in this plan, which allows them to purchase Costco stock by payroll deduction.

HEALTH CARE REIMBURSEMENT ACCOUNT

Benefit-eligible employees can arrange to have pre-tax contributions automatically deducted from their paychecks and placed into a Health Care Reimbursement Account.

LONG-TERM CARE INSURANCE

Designed to pay for nursing home care, Costco provides a basic policy for employees with 10 or more years of service.

According to a 2014 report published by glassdoor.com, Costco is the number two company to work for based on compensation and benefits (Google is number one). The Glassdoor ranking is based on employees’ opinions of their employer’s benefit and compensation package. The company received a 4.4 out of a possible 5 for compensation and benefits, and 3.8 out of 5 for total employee satisfaction. In addition, 82% of Costco employees would recommend the company to a friend. CEO Craig Jelinek has a 92% approval rating among employees. Reviews posted on the site by employees praising the Costco work environment said, “The best incentive at Costco is the benefits, whether you are working full time or part time. I paid 20 bucks a month for a $500 deductible with no co-pay. The hourly compensation is more than fair, and I got the sense very quickly that management was eyeing the most competent workers for advancement.” “Great wages, benefits . . . and working for a great company that really truly cares about their members and employees.”

Questions

1. What organizational processes does compensation affect, and what is Costco’s rationale for having an exceptional compensation plan?

2. What are the parts of a compensation system, and what component(s) does Costco’s compensation system focus on?

3. What are the four basic types of compensation, and which are evident at Costco?
4. What is expectancy theory, and how does or does not Costco employ this theory within their compensations system?
5. What are the differing types of basic wage classifications, and how does Costco categorize their workforce by basic wage?
6. What is Costco’s philosophy about employee compensation?
7. Costco lists numerous benefits that the firm provides employees above their basic salary. What pay rate and benefits must Costco provide their employees as required by federal labor laws?

Case created by Herbert Sherman, PhD, and Theodore Vallas, Department of Management Sciences, School of Business Brooklyn Campus, Long Island University

### Skill Builder 10.1 Job Evaluation

#### Objective
To develop a better understanding of the job evaluation process.

#### Skills
The primary skills developed through this exercise are as follows:

1. *HR management skills*—Technical, conceptual and design, and business skills
2. *SHRM 2018 Curriculum Guidebook*—B: Compensation and Benefits

#### Assignment

*Step 1.* You decided to open a restaurant and pub, and you have five job categories:

- **Owner/manager:** You are the owner, performing all the management functions and also greeting and seating people as you oversee all activities.
- **Wait staff:** They take food orders and bring food to customers.
- **Cook:** They prepare the food.
- **Helpers:** They bus tables, wash dishes, help in food preparation, and bring food to some customers.
- **Bartenders:** They make the drinks for both the dining and bar areas.

Rank the jobs from 1 to 5, with 5 being the highest-ranking job and 1 being the lowest.

<table>
<thead>
<tr>
<th>Job</th>
<th>Mental Requirements (education, intelligence, and specialized knowledge)</th>
<th>Physical Requirements (effort such as standing, walking, and lifting)</th>
<th>Skill Requirements (specific job knowledge/training to do work)</th>
<th>Responsibilities (for equipment, money, public contact, and supervision)</th>
<th>Working Conditions (safety, heat, ventilation, and coworkers)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manager</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wait Staff</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cook</td>
<td></td>
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</tr>
<tr>
<td>Helper</td>
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</tr>
<tr>
<td>Bartender</td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Factor Rank (1–5)</td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weight (100%)</td>
<td></td>
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</tr>
</tbody>
</table>
Step 2. Using the table, rank each job for each of the five factors commonly used in job evaluations.

Step 3. The five factors are commonly weighted since some are more important than others.

(A) In the table in the row with the heading “Factor Rank,” rank the five factors from 1 to 5, with 5 being the most important and 1 being the least important.

(B) The five factors can also be weighted as percentages. For example, based on a total of 100%, the highest-rated factor could be weighted at 40%, then the next-highest could be rated at 30%, followed by 20%, and the other two at 5% each. Also include your percentage-based weights for each factor, as in the example.

People generally will not agree on all the rankings, and that is a major reason why there is virtually always a committee that conducts job evaluations.

Step 4 (optional due to difficulty). Assign pay values to each of the five factors and weight them to determine pay levels for each job.

Apply It

What did I learn from this experience? How will I use this knowledge in the future?

____________________________________________________

____________________________________________________

____________________________________________________

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Skill Builder 10.2 Product Market Competition Limits

Objective

To develop a better understanding of product market competition limits

Skills

The primary skills developed through this exercise are as follows:

1. HR management skills—Technical and business skills
2. SHRM 2018 Curriculum Guidebook—B: Compensation and Benefits

Assignment

Complete the math problems below.

_____ 1. Your product sells for $1,000. Materials cost $300, labor costs $300, and overhead costs $200. What is your profit in dollars and as a percentage?

_____ 2. Your product sells for $750. Materials cost $250, labor costs $300, and overhead costs $150. What is the profit in dollars and as a percentage?

_____ 3. Your product sells for $1,000. Materials cost $300 and overhead costs $200. What is the maximum amount you can pay labor to make a $100 profit with a 10% return?

_____ 4. Your product sells for $750. Materials cost $250 and overhead costs $150. What is the maximum amount you can pay labor to make a 10% profit return on the sales price?

_____ 5. Your product sells for $800. Materials cost $300 and overhead costs $200. What is the maximum amount you can pay labor to make a 15% profit return on the sales price?