TOMORROW'S COMPENSATION AND REWARDS SHAPED BY TODAY'S CHOICES

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Today's trends shape tomorrow. This is as true for the weather as it is for the way people are paid. Employee compensation in the future is being shaped by the choices we make today. So, by examining these choices, we can sketch a picture of tomorrow's compensation. This isn't to say that the past predicts the future. This is no more true in our field than it is in weather forecasting. But by analyzing the forces affecting today's trends, we are better able to understand tomorrow. And, I believe it is important to understand how employee compensation will be determined and what the consequences of different approaches will be. For the way employees are compensated affects their financial well being, their skills and knowledge and their self worth. Compensation directly impacts the economic effectiveness of employers and the talents of a nation's human resources. Finally, the way employees are compensated exhibits society's sense of social justice.

My remarks are based on three premises. One is the discontinuity of change. That industrial relations systems in North America are changing is yesterday's news. Employee compensation, woven into the fabric of these systems, is changing, too. Yet change is nothing new in employment relationships. There is, however, discontinuity to change. The pace of it varies. While a history of employment relationships and compensation is beyond the scope my remarks, those who believe that we are at some unique watershed need only to examine the history of North American employment relations to find that change is endemic to market-based economies. Continuous remolding and recasting of assets and the attendant, often disruptive consequences for employment relations is the heart and soul of our field. Those who believe that the employment relationships of the last 25 years were going to continue into the 90's and beyond were asleep in their history class. And those who don't know the history of employment relationships don't learn from it.

My second premise is that changes in pay practices reflect deliberate choices which shape future employment relations. Negotiating performance-based increases in lieu of across-the-board provisions, replacing multilayered structures with banded ones, including customer satisfaction and total quality in performance evaluation are deliberate choices made by the stakeholders involved in determining pay. These choices shape the things to come.

My belief that differences in employee compensation matter is the third premise. Employee compensation is strategic; hence differences or changes in the way employees are paid affects an organization's ability to achieve and sustain competitive advantage. It affects employees financially and personally and it impacts the preparedness of a society's human resources and signals its human values.

MAJOR TRENDS SHAPING TOMORROW

Some of the major trends shaping the future of employee compensation are shown in Figure 1. The shift in perspective from administration to an emphasis on competitive advantage is fundamental. Answers to very different questions are now being sought. Rather than searching for how to more efficiently and fairly to administer pay, the questions become, What is the impact of different approaches to employee compensation? What forms of employee compensation help achieve competitive advantage? What impact do different approaches have in different contexts? More specifically, what do administrative procedures such as job evaluation, market wage surveys, performance appraisal, gainsharing and the like, contribute to an organization's success? To the well being and work-behaviors of employees? What do these procedures signal about social justice in society?

FIGURE 1

TODAY'S TRENDS SHAPING TOMORROW'S COMPENSATION

From	To
Administrative Focus	Competitive Advantage
Responding to Patterns	Competitive Positioning
Wages and Benefits	Total Labor Costs
National Focus	Global Competitiveness
Base and Annual Increase	Base and Performance/ Quality Increase
Internal Equity	Support New Organization Designs
Benefits Entitlement	Cost Shifting; Value Added; Public Policy

While this trend toward better understanding the impact of different forms of pay and pay procedures is most apparent in the private sector, the public sector is also changing. Recently, I chaired a joint labor management committee mandated by the U.S. Congress to examine how to strengthen the link between federal employees' pay and performance. Ensuring fair treatment of employees through bureaucratic regulations remained a vital concern. Yet, how to better serve the taxpayers was also a major concern of the federal managers and employee union presidents who served on my committee. So, even the U.S. federal government is showing some signs of understanding that pay affects performance. Sustaining competitive advantage for public sector agencies eventually translates into tradeoffs between publicly provided services and privatization.

Another trend affecting tomorrow's compensation is the shift away from responding to negotiated or "benchmark" patterns to competitive positioning. Rather than simply mimicking the pay decision of others, or playing follow-the-leader, there are signs that decisions are being tailored to help position the organization competitively.

The recent Caterpillar - United Auto Workers dispute illustrates the point. The UAW was trying to achieve an agreement that followed the pattern negotiated with other employers. Caterpillar, on the other hand, recognized that differences in employee compensation and work rules impacted their competitive position in their global markets. Caterpillar's competitors are global, but the UAW focused on the pattern of domestic agreements. Recognizing the critical importance of pay decisions on an employer's position relative to its global competitors, Caterpillar wished to tailor their pay to their unique circumstances rather than blindly follow patterns or benchmarks established by others.

Perhaps the most important trend listed in Figure 1 is the growing emphasis on managing total labor costs. Each factor in the labor cost equation remains important, but the shift is to a total labor cost analysis beyond separately analyzing each factor. As a result, there is increased efforts in analyzing competitor's labor costs not simply surveying competitor's wages and benefits. Part and parcel of this focus on labor cost is that more attention is devoted to examining the workforce composition; ----- the percentage of employees that should be core, contingent, and contract workers. Further, the increased interest in total labor costs, has resulted in changes in the form of increases. Increases in pay are shifting from fixed (which are permanently added to base) to variable (which increase or decrease with performance) and improvement in benefits coverage often involves cost sharing with employees.

The uncertainty over the annual pay improvement is another trend. Most of us, over our careers, have been reasonably certain that each year will bring a pay increase. (Except at Cornell, where we are in our third year of wage freezes coupled with increasing health care deductions). But the annual increase is becoming more contingent on achieving performance targets. At least there is more rhetoric about making pay increases more risky and more dependent on performance. There is enough of the skeptic in all of us to ask whose pay will really be at risk --- executives? Teachers? Civil servants? And dependent on whose performance? Just how fairly will this risk be shared?

Another trend is the change from a national to a global focus. Clearly, everyone in North America is increasingly more globally aware. Canadians historically have been, the United States has become so. This translates into monitoring cross-national labor cost comparisons, to international wage surveys and to becoming more knowledgeable about the differences in international health and benefit policies.

The recognition that there is more to internal pay relationships than internal equity is also shaping the future. Through the 1980's, pay equity in North America was increasingly narrowly defined. By the mid-80's, pay equity came to refer to the pay received by women who performed predominantly office and support work compared to the pay received by men. Important as this issue remains, it overshadowed the purposes served by internal pay structures. Questions about optimal internal pay relationships and the purposes they are designed to achieve are again being raised. Bureaucratically-based approaches are being replaced by experiments with banding, knowledge-based structures, generic job descriptions and the like. In the process, questions about the appropriate number of pay levels and size of differentials to support more flexible, organization designs are being analyzed. In addition, there is a growing realization that the differences in pay received by executives compared to other employees may affect employees' willingness to buy into visions about high involvement and total quality.

Finally, more important than differences in CEO and other employees' pay are the differences in how core versus contingent workers are paid. Core employees, those with longer term relationships with a single employer, continue to receive the most attention. Yet, the treatment of contingent [define] workers also affects the organization's success and society's future. The risks and returns inherent in the employment relationships with flexible workers (i.e., part-timers and temporaries), with the contract fringe (i.e., self-employed professionals and consultants) and with suppliers (i.e., employees of strategic partners) are increasingly important. If contingent workers decide they are bearing relatively greater economic risks with less opportunities for returns than a privileged core, surely they will seek political or social redress. Once again, those who don't know the history of North American employment relationships don't learn from it.

In sum, future compensation is being shaped by the shift from concerns over internal pay equity to those centered on internal consistency; the impact of pay structures on the changing designs of organizations and its effects on employees' behaviors.

Perhaps the greatest change in future compensation will be in employee benefits that are directly linked with employment. Health and medical benefits are the current example. Canada and Quebec are further into their experience with national health care policies and the appropriate responsibilities of employers, government, and individuals. Below the border, the United States is in an earlier stage of its debate. Shifting costs, coverages and responsibilities are critical issues. But beyond this debate is a fundamental question; --- What is the value added, for all stakeholders from offering benefits beyond those mandated? Do they really offer any advantages in helping attract and maintain a workforce, or influence its performance? And what difference does variations in benefits among employees really make? Or are benefits only a means to circumvent income tax laws? A recent study in the U.S. estimates about $90 billion in revenues would result if benefits were taxed in the U.S. What does adopting flexi-time, flexi-place, flexi-benefits really affect besides costs? We believe that benefits pay off, but the evidence is sparse.

FORCES CAUSING CHANGE

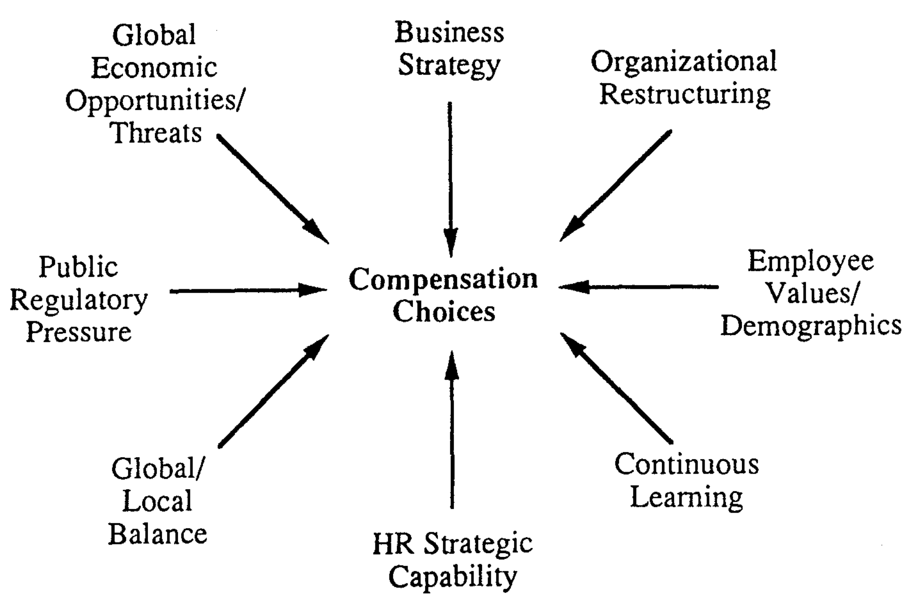
Why are these changes in employee compensation occurring? Why is the pace accelerating? It is in response to pressures just as changing weather patterns are. Some of these pressures are shown in Figure 2. I'm not going to discuss each of these pressures and trace their effects. It is noteworthy, however, that different organizations respond differently to these pressures. Some, as if jolted by an earthquake, make revolutionary changes. The response of others is more evolutionary. Merck, a highly successful pharmaceutical, illustrates an evolutionary response. They are offering the types of compensation usually paid to top managers, to all employees throughout the organization --- variable-performance based, stock options, and bonuses based on subunit performance. This change is occurring incrementally over time. There are many examples of revolutionary responses. Polaroid, an optics firm, first established a vision for their human resource policies ..... establishing a continuous learning organization. Then, they adopted an applied knowledge plan to replace job evaluation. This requires employees to seek increases to their base pay through gaining knowledge and skills, rather by promotions in job levels. Historically, Polaroid paid base salaries which lead its competitors. With the new plan, base pay was repositioned to lag their competitors by 5%. An additional 2%, funded an annual bonus tied to Polaroid's corporate performance. So, Polaroid employees can now receive earnings that lead competitor's pay. But depending on Polaroid's performance, their earnings may lag what competitors are paying.

Merck and Polaroid have responded very differently to similar pressures. The key question, of course, is does it really matter? Will these two employers be better off? Will their employees? These organizations differ in their beliefs about how compensation will help them achieve competitive advantage.

FIGURE 2

WHY TRANSFORM?

FORCES CAUSING CHANGE



INTERNATIONAL VIEWS

Looking beyond these two examples, a study commissioned by IBM provides insights into international responses to the pressures shown in Figure 2. TPF&C, an international consulting firm, asked 3000 opinion leaders in 12 countries the following question: "What human resource policies will help organizations compete in the year 2000 and beyond?" The results suggest four priorities for achieving competitive advantage; (1) Resourcing and developing a skilled workforce, (2) Organizing and developing these skills, (3) Rewarding desired results and (4) Communicating and motivating performance. These last two deal directly with compensation. Examining the results further reveals some interesting differences and similarities among different countries. The 300 Japanese experts agreed (75% or more) that 3 specific actions were critical: (1) Communicate business directions and problems to inform employees about the business and the problems they faced, (2) Identify high potential employees, and (3) ---- and this is the interesting one for us --- focus on a merit pay philosophy and recognize individual performance. Over 75% of the Japanese experts, drawn from business, government, labor and universities, agreed that rewarding individual performance, and following a merit policy was critical.

FIGURE 3

Responding to Pressures:
Priorities for Competitive Advantage

Japanese Responses

* **Communicate Business Directions and Problems**
* **Identify High Potential Employees**
* **Focus on Merit Philosophy and Individual Performance**

The French experts' response, Figure 4, reveal consensus (75% or more) on seven actions. Two of these seven are related to compensation; (1) rewarding employees for customer service and quality and (2) focusing on merit pay and individual performance. So, the French, perhaps some less than the Japanese, believe that pay is important to achieving competitive advantage.

FIGURE 4

Responding to Pressures:
Priorities for Competitive Advantage

French Responses

- **Identify high-potential employees early**
- **Communicate business directions, problems, plans**
- **Peer/subordinate/customer ratings**
- **Reward employees for customer service/quality**
- **Require employee flexibility (re: jobs, location)**
- **Focus on merit philosophy, individual performance**
- **Require employees to self-monitor/improve**

FIGURE 5

**Responding to Pressures:
Priorities for Competitive Advantage**

Canadian Results

* Communicate business directions, problems, plans
* Reward employees for customer service/quality
* Facilitate full employee involvement
* Reward employees for business/productivity gains
* Require continuous training/retraining
* Identify high potential employees early
* Reward employees for innovation/creativity
* Implement pay systems promoting sharing
* Require employee flexibility (re: jobs, location)
* Require employees to self-monitor/improve
* Promote employee empowerment via ownership

FIGURE 6

Responding to Pressures:
Priorities for Competitive Advantage

U.S. Responses:

* **Reward Employees for Customer Service**
* **Communicate Business Directions/Problems/Plans**
* **Reward Employees for Business/Productivity Gains**
* **Reward Employees for Innovation and Creativity**
* **Implement Pay Systems Promoting Sharing**
* **Identify High-Potential Employees Early**
* **Promote Employee Empowerment through Ownership**

Canadian results, shown in Figure 5, show consensus on eleven actions; four of these are pay related. The Canadians were in greater agreement than the French or Japanese. U.S. experts agreed, as shown in Figure 6, that seven actions are important; four are pay related.

If we cull these results, the following messages emerge from experts across those countries: (1) compensation matters. It can impact competitive advantage; (2) Link pay increases to the performance of the organization; and (3) Strengthen the relationship between pay and innovation and creativity. National differences emerged over the importance of individual versus group performance. The U.S. and Canadians believe team and group performance is important in pay; the French and Japanese advocate recognizing individual performance with pay. This difference may reflect historic patterns; North Americans have traditionally valued individual performance and are shifting emphasis to include groups, whereas the Japanese and French are tempering their longer emphasis on collective effort with some recognition of individuals. Other differences included the importance of pay relative to other actions and the consensus among the experts.

RESEARCH GUIDES CHOICES

The trends observed today are, the result of choices, choices made in response to pressures and in the belief that they will have an effect. Beliefs are, in effect, personal theories based on experience about the influence of pay. Sound research also helps inform decision makers. Over the past few years, my colleagues and I at Cornell have conducted a series of studies designed to analyze the impact of employee compensation. The results of this work help inform policymakers about the impact of the choices they are making regarding different compensation trends I've discussed.

In one study, compensation directors of 200 multi-nationals were asked which pay decisions are critical to the success of their business. Five policy choices emerged from their responses: (1) Aligning compensation policies with the organization's strategic intent, (2) Positioning total labor costs relative to their global competitors', (3) Strengthening pay for performance, (4) Structuring pay internally to support the organization's objectives, and (5) Managing change to help insure that employees are treated fairly. These are the strategic policy decisions, according to those managers who are responsible for the compensation systems of major organizations. Strengthening the pay for performance relationship is the focus of the remainder of my remarks.

STRENGTHENING THE PAY-FOR-PERFORMANCE RELATIONSHIP

Figure 7 acts as a guide to the tremendous variety of performance-based pay programs used in North America. It organizes programs on two dimensions, (1) according to the level at which performance is measured (i.e., individual or group as in teams, units or corporate); (2) whether the pay increases are permanently added to base pay or are variable. Merit pay, for example, is based on performance measured at the individual level and adds into base pay. Gainsharing is based on group level performance and does not add into base pay.

FIGURE 7

A GUIDE TO VARIABLE PAY PLANS

Level
Performance Measurement

	Individual		Group
Add In	Merit		
Not Add In	Awards Piece Rates Commissions	Bonuses	Gainsharing Profit Sharing Stock Options

It's interesting to note that few performance-based pay programs listed in the grid are devoted to long term performance. Despite the widespread criticism that North Americans are too short-sighted, short-term performance remains the focus of the vast majority of the programs. The majority of the programs also involve risk sharing. I'm going to illustrate how the Cornell research helps inform policy choices about two types of programs: variable pay and merit pay.

VARIABLE PAY According to recent surveys, profit sharing and gainsharing are the two most widely used forms of variable pay. A recent survey by Hewitt suggests that the use of these plans may have peaked, but other surveys by Wyatt, the Conference Board and Bureau of National Affairs suggests otherwise. According to these latter surveys, about 20 percent of the firms in their samples use gainsharing in some facilities and about 30-40% use some form of profit sharing. These plans come in many shapes and sizes; most seem to be tailored to the unique circumstances. They are in both union and non-union settings. Bonus and profit sharing plans based on corporate and subunit performance targets are most common for managers and professionals; gainsharing based on facilities or team performance measures are used for non-management employees.

I believe that the principal reason underlying the widespread interests in variable pay plans is that they help control labor costs and they shift risks to employees. Nevertheless, much of the rhetoric emphasizes success sharing, empowerment and high commitment. While these objectives are also involved, the core features of these programs are variable and short term ---- making a part of increases in labor cost variable with quarterly or annual performance. Beyond this, they communicate to employees that at least some part of their pay increases are at risk, based on achieving facility and/or corporate objectives. A union leader points out that union members have to meet their mortgage payments, medical bills, and so on. Those expenses don't vary based on their employer's performance. By placing employees' earnings at risk, their lifestyle and economic well-being is placed at risk. So, until personal expenses vary with employees performance, this leader cautions his membership to avoid taking on risk with their earnings. But the other side of this argument is that employability and jobs may be more secure if wages become more flexible. Better to vary earnings somewhat than to have no earnings at all ---- so goes the counterpoint.

What does the research tell us about the impact of these plans? The preponderance of evidence is that gainsharing has resulted in performance improvements of between 15-25%. These results are drawn from a number of studies. Performance is variously measured as quality improvements, customer satisfaction indices, safety and so on. The longest time period for any study was about 5 years (1 study). Most only report data from the first year to 18 months. A belief among some is that diminishing returns occur over the life on success sharing plans. Hence, flexible objectives are an important design feature. Perhaps most informative of all studies are the failures. Much can be learned from failures. There seems to be agreement that sound, technical design features of these programs are not sufficient for success. Process matters. Specifically, failures are less likely when trust is built between employee and the leadership, relevant data on operations and financials is reliable and shared, employees are knowledgeable about customers needs, and "lines of sight" between employees and performance measures are created.

In sum, these variable pay plans are most likely to be successful when they are woven into the fabric of a total employee relations approach.

Recently, we completed a study of the impact of managerial bonus plans in 280 firms covering five years. What we found surprised us. We discovered that it's not how much you pay but how you pay that matters. To be sure, the firms differed in their relative level of pay --- how they positioned themselves against their competitors. We expected to find these differences. But these differences -- had no impact on financial performance. However, those firms that paid more in bonuses relative to base pay performed better. Specifically, increasing the ratio of bonus over base by 10% led to a

0.95% increase in return on assets. This is an amazing find. We were able to find a relationship between bonus plans and the subsequent financial success of firms. Further, we found that those firms which had more managers eligible for long term incentives (e.g., stock options) also performed better. Specifically, a 10% increase in eligibility yielded about a 0.17% improvement in returns on assets. But beware the technician among us. Don't neglect what has been learned from the failed gainsharing experiences --- process matters, too.

Merit Pay Merit pay is clearly the most widely used performance-based pay approach in North America. Surveys report that it applies to about 90% of managerial, professional and technical employees. Yet, it is being seriously mismanaged. Too much money is going to too many people with too little effect. Consider a typical merit pay increase. In the U.S., a satisfactory performer receives about 5%. For a $40,000 a year person, that yields $2,000 annually, which translates to about $44.00 bi-weekly after U.S. taxes. But star performers typically receive 8%, which translates into a difference of about $32.00 bi-weekly from the satisfactory performer. Enough of a difference to make a difference? But let's be clear about what merit has become. Merit pay is a cost control, budgetary device, not a performance-based plan. Merit grids, the technique typically used, regulate increases based on position in range and the performance appraisal distribution. These grids are in reality budgeting, not performance improvement, devices. Correcting this is straightforward ---- simply make the percent differences between poor, satisfactory and star performers larger. Yes, it will cost more, given the currently skewed performance ratings. But, if the purpose is to motivate performance, then let's design a merit pay plan. If the purpose is to budget pay increases, then the approach currently in use is working just fine.

It's not only current managers who share the responsibility for the mismanagement of merit pay. Those of us in the research community share this responsibility, too. So much money is devoted to so-called merit pay, yet there is virtually no research that informs us about the effectiveness of these programs. Opinions and beliefs are rife, but sound research is rare.

Permit me to summarize the major points of my remarks.

* The way people are being paid is changing. While change is a feature of market based economies, its pace has picked up again.
* Today's policy choices are shaping tomorrow's compensation. The trends we observe today reflect the choices made by stakeholders. The choices made are in response to a variety of pressures and are primarily based on beliefs and experiences.
* Experts suggest that employee compensation is strategic, it can help achieve competitive advantage. Though the experts don't always agree on how this gets done.
* Sound research informs us that what matters is how you pay, not how much you pay. Total pay relative to competitors (within limits) is not related to future financial performance. Rather, bonuses, gainsharing and profitsharing, ---- the forms of pay, ---- are related to subsequent performance. Research also tells that process matters. Informed, involved employees make performance-based plans work. Finally, merit pay is a misnomer. Actually, basing pay on merit requires funding, recognizing performance differences and changing eligibility. Research is underway on the relative payoffs of various approaches to performance based pay.

All the trends discussed here have already happened, it is only their full impacts that are still to come. Most of these developments are not new to you, leading you to nod and say, "Of course." But one of my points is to get you to shift your response from "Of Course;" to "What do these changes mean for my own work --- for my own organization?" For I believe that all these developments in employee compensation signal a fundamental change in the very nature of the social contract among employees, employers and governments. Implicit understandings, reciprocal obligations and returns among the stakeholders have shifted. Reciprocal understandings about the nature of wages, benefits, employability and the like are being remolded. As Figure 8 suggests, the social contract with employees is a critical factor in achieving competitive advantage. Yet most of the attention of managers, administrators and researchers is devoted to the impact of the organization's strategic, economic and political pressures on policy choices. The impact of the changing social contract with employees has been virtually ignored. Yet without concern for social justice and fair treatment of employees, tomorrow's competitive advantages may well be impossible to achieve.

Managing Choices to Achieve Competitive Advantage Depends On Employees