Learning Objectives

• Compensation strategy: External competitiveness
• What shapes external competitiveness?
• Labor market factors
• Modifications to the demand side
• Modifications to the supply side
• Product market factors and ability to pay
Learning Objectives

- Organization factors
- Relevant markets
- Competitive pay policy alternatives
- Consequences of pay-level and mix

Decisions: guidance from the research
## Compensation Strategy: External Competitiveness

**External competitiveness**

- Is expressed by:
  - Setting a pay level that is above, below, or equal to that of competitors
  - Determining the mix of pay forms relative to those of competitors

- Refers to the:
  - Pay relationships among organizations
  - Organization’s pay relative to its competitors
Compensation Strategy: External Competitiveness

- **Pay level**
  - The average of the array of rates paid by an employer

- **Pay forms**
  - Various types of payments, or pay mix, that make up total compensation

- **Objectives**
  - Control costs and increase revenues
  - Attract and retain employees
Control Costs and Increase Revenues

- Labor costs = Pay level X number of employees
- Higher the pay level, greater the labor costs
- Higher the pay level relative to what competitors pay:
  - Greater the relative costs to provide similar products or services
Attract and Retain the Right Employees

• Pay rates for similar jobs vary among employers
• Companies set different pay-level policies for different job families
• Comparisons regarding pay are based on:
  • Companies setting different pay-level policies for different job families
  • What competitors the company compares to and what pay forms are included
Exhibit 7.5 - What Shapes External Competitiveness?

LABOR MARKET FACTORS
Nature of Demand
Nature of Supply

PRODUCT MARKET FACTORS
Degree of Competition
Level of Product Demand

ORGANIZATION FACTORS
Industry, Strategy, Size
Individual Manager

EXTERNAL COMPETITIVENESS
Labor Market Factors

- Types of markets
  - Quoted price
    - Example - Stores that label each item’s price
  - Bourse
    - Example - eBay allows haggling over the terms and conditions
- In both markets:
  - Employers are the buyers and potential employees are the sellers
How Labor Markets Work

• Assumptions
  • Employers always seek to maximize profits
  • People are homogeneous and therefore interchangeable
  • Pay rates reflect all costs associated with employment
  • Markets faced by employers are competitive
Exhibit 7.6 - Supply and Demand for Business School Graduates in the Short Run
Labor Demand

• Analysis of labor demand:
  • Indicates how many employees will be hired by an employer

• Marginal product of labor
  • Additional output associated with the employment of one additional person:
    • With other production factors held constant
  • Diminishing marginal productivity
    • Each additional employee has a progressively smaller share of factors of production
Labor Demand

• Marginal revenue of labor
  • Additional revenue generated when:
    • The firm employs one additional person while other production factors are constant
  • A manager using the marginal revenue product model must determine:
    • Pay level set by market forces
    • Marginal revenue generated by each new hire
Exhibit 7.7 - Supply and Demand at the Market and Individual Employer Level
Labor Supply

• This model assumes:
  • Many people are seeking jobs
  • People possess accurate information about all job openings
  • No barriers to mobility exist
Modifications to the Demand Side

- Economic theories must frequently be revised to account for reality
- Issue for economists
  - Why would an employer pay more than the market-determined rate?
## Labor Demand
### Theories and Implications

<table>
<thead>
<tr>
<th>Theory</th>
<th>Prediction</th>
<th>So What?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensating Differentials</td>
<td>Work with negative characteristics requires higher pay to attract/retain workers</td>
<td>Job evaluation and compensable factors must capture these negative characteristics</td>
</tr>
<tr>
<td>Efficiency Wage</td>
<td>Above market wage/pay level will improve efficiency by attracting higher ability workers and by discouraging shrinking because of losing high wage job. A high wage policy may substitute intense monitoring.</td>
<td>The pay off to a higher wage depends on employee selection systems ability to validly identify best workers. An efficiency wage policy may require the use of few supervisors.</td>
</tr>
</tbody>
</table>
# Labor Demand Theories and Implications

<table>
<thead>
<tr>
<th>Theory</th>
<th>Prediction</th>
<th>So What?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sorting and Signaling</td>
<td>Pay policies signal to applicants the attributes that fit the organizations. Applicants may signal their attributes by investments they have made in themselves</td>
<td>How much, but also how pay mix and performance will influence attraction-selection-attrition and resulting work force composition</td>
</tr>
<tr>
<td>Job Competition</td>
<td>Job requirements may be fixed. Workers compete for jobs based on qualifications and not how low wages they are willing to accept. Thus wages are sticky downward</td>
<td>As hiring difficulties increase, employers should expect to spend more to a) train new hires, b) to increase compensation, c) search/recruit more</td>
</tr>
</tbody>
</table>
Compensating Differentials

- Explain the presence of various pay rates in the market
- Hard to document due to:
  - Difficulties in measuring and controlling various pay rates
Efficiency Wage

• High wages may increase efficiency and lower labor costs if they:
  • Attract higher-quality applicants
  • Lower turnover
  • Increase worker effort
  • Reduce shirking
  • Reduce the need to supervise employees
Efficiency Wage

• Greater profits than competitors allows share success with employees by:
  • Leading competitors’ pay levels
  • Bonuses that vary with profitability
• Rent sharing-return received from activities that are:
  • In excess of the minimum needed to attract people to those activities
Sorting and Signaling

• Designing pay levels and mix as part of a strategy that:
  • Signals employees kinds of behaviors sought

• Employer signals
  • Organization decisions about:
    • Pay level (lead, match, lag)
    • Pay mix (higher bonuses, benefit choices)

• Employee signals
  • Applicant characteristics (degree, grades, experience)
## Exhibit 7.9 - Labor Supply Theories and Implications

<table>
<thead>
<tr>
<th>Theory</th>
<th>Prediction</th>
<th>So What?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reservation wage</td>
<td>Job seekers will not accept jobs with pay below a certain wage, no matter how attractive other job aspects.</td>
<td>Pay level will affect ability to recruit.</td>
</tr>
<tr>
<td>Human capital</td>
<td>The value of an individual’s skills and abilities is a function of the time and expense required to acquire them.</td>
<td>Higher pay is required to induce people to train for more difficult jobs.</td>
</tr>
</tbody>
</table>
Product Market Factors and Ability to Pay

- **Product Demand**
  - Limits maximum pay level an employer can set

- **Degree of competition**
  - Highly competitive markets
    - Lesser ability to raise prices without loss of revenues
  - Single sellers are able to set whatever price they choose
Segmented Supplies of Labor and (Different) Going Rates

• People flow to the work
  • A segmented labor supply involves:
    • Multiple sources of employees
    • From multiple locations
    • With multiple employment relationships
  • Level and mix of cash and benefits paid depends on the source
Segmented Supplies of Labor and (Different) Going Rates

- Work flows to the people—on site, off-site, offshore
  - Determining pay levels and mix requires:
    - Understanding market conditions in different locations
  - Managers need to know:
    - Jobs required to do the work
    - Tasks to be performed
    - Knowledge and behaviors required to perform them
Organization Factors

- Industry and technology
  - Labor-intensive industries tend to pay lower than technology-intensive industries
  - New technology within an industry influences pay levels
- Employer size
  - Large organizations tend to pay more than small ones
Organization Factors

- People’s preferences
  - Determine external competitiveness
  - Markets involve employers’ and employees’ choices

- Organization strategy
  - Low-wage, no-services strategy
  - Low-wage, high-services strategy
  - High-wage, high-services strategy
Relevant Markets

• Determined on the basis of:
  • Occupation
  • Geography
  • Competitors

• Chosen on the basis of:
  • Competitors - Products, location, and size
  • Jobs - Required skills and knowledge
Relevant Markets

Data from product market competitors receives greater weight when:

- Employee skills are specific to the product market
- Labor costs are a large share of total costs
- Product demand is responsive to price changes
- Supply of labor is not responsive to changes in pay
Globalization of Relevant Labor Markets: Offshoring and Outsourcing

Factors to consider while deciding where job location

- Labor costs and productivity
  - Countries with lower average labor costs tend to have lower average productivity
- Agency theory
  - Devote resources to systems that monitor worker effort or output
- Customer reaction
- How long the labor cost advantage will last
Competitive Pay Policy Alternatives

• Conventional pay-level policies
  • To lead, to meet, to follow competition

• Newer policies
  • Emphasize flexibility among:
    • Policies for different employee groups
    • Pay forms for individual employees
    • Elements of the employee relationship that company wishes to emphasize
Exhibit 7.11- Probable Relationships Between External Pay Policies and Objectives

<table>
<thead>
<tr>
<th>Policy</th>
<th>Compensation Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ability to Attract</td>
</tr>
<tr>
<td>Pay above market (lead)</td>
<td>+</td>
</tr>
<tr>
<td>Pay with market (match)</td>
<td>=</td>
</tr>
<tr>
<td>Pay below market (lag)</td>
<td>–</td>
</tr>
<tr>
<td>Hybrid policy</td>
<td>?</td>
</tr>
<tr>
<td><strong>Employer of choice</strong></td>
<td>+</td>
</tr>
</tbody>
</table>
Pay with Competition (Match)

- Wage costs
  - Approximately equal to those of its product competitors
- Ability to attract potential employees
  - Approximately equal to its labor market competitors
- Avoids placing an employer at a disadvantage in pricing products
Lead Pay-Level Policy

• Maximizes the ability to attract and retain quality employee
• Minimizes employee dissatisfaction with pay
• May offset less attractive features of work
• May lead to dissatisfaction
  • If used only to hire new employees
• May mask certain negative attributes
Lag Pay-Level Policy

- May hinder a firm’s ability to attract potential employees
- Coupled with the promise of higher future returns:
  - May increase employee commitment
  - Foster teamwork
  - May possibly increase productivity
Different Policies for Different Employee Groups

• Employers may vary the policy for:
  • Different occupational families
  • Different forms of pay
  • Different business units

• Pay-mix strategies may be:
  • Performance driven
  • Market match
  • Work/life balance
  • Security
Exhibit 7.15 - Pay-Mix Policy Alternatives

Performance Driven
- Benefits: 17%
- Options: 16%
- Bonus: 17%
- Base: 50%

Market Match
- Benefits: 20%
- Options: 4%
- Bonus: 6%
- Base: 70%

Work/Life Balance
- Benefits: 30%
- Options: 10%
- Bonus: 10%
- Base: 50%

Security (Commitment)
- Benefits: 20%
- Base: 80%
Employer of Choice/Shared Choice

• Employer of choice
  • Corresponds to the brand the company projects as an employer

• Shared choice
  • Begins with traditional options of lead, meet, or lag
  • Offers employees choices in the pay mix
  • Risks
    • Employees will make “wrong” choices
    • Offering too many choices may lead to confusion, mistakes, and dissatisfaction
Exhibit 7.16 - Volatility of Stock Value Changes Total Pay Mix

Stock Value Declines 50%

Before

Options 28%
Bonus 8%
Base 47%
Benefits 17%

After

Options 16%
Bonus 10%
Base 55%
Benefits 19%
Exhibit 7.17 - Dashboard: Total Pay Mix Breakdown vs. Competitors’

Stock Options 79%
Base Salary 95%
Benefits 103%
Bonus 113%
Perquisites 122%

*100 = Chosen market position, e.g., market median
Exhibit 7.19 - Some Consequences of Pay Levels

- Contain operating expenses (labor costs)
- Increase pool of qualified applicants
- Increase quality and experience
- Reduce voluntary turnover
- Increase probability of union-free status
- Reduce pay-related work stoppages
Consequences of Pay-Level and Mix Decisions: Guidance from the Research

- **Efficiency**
  - No research suggests:
    - Under what circumstances managers should choose which pay-mix alternative
  - Pay level may not gain any competitive advantage
    - Wrong pay level may be a serious disadvantage
Consequences of Pay-Level and Mix Decisions: Guidance from the Research

• Fairness
  • Satisfaction with pay is directly related to pay level
  • Sense of fairness is related to how others are paid
Consequences of Pay-Level and Mix Decisions: Guidance from the Research

• Compliance
  • Employers must pay at or above the legal minimum wage
  • Prevailing wage laws and equal rights legislation must be met
  • Pay forms are regulated
  • Caution must be exercised when sharing salary information