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ABSTRACT

Although what the work companies do and how they do it have shifted significantly, companies' reward and salary structures have remained largely the same; however, a properly designed compensation and pay system can be a strategic tool to enhance a firm's competitiveness. New approaches tie pay more closely to performance, rather than to tenure and entitlement. They encourage organizational performance and enhance a closer connection between employee and organizational goals by enabling employees to share more fully in the rewards and risks of the enterprise. Variable pay, a core element in new pay approaches, also helps companies promote long-term employment security by providing for pay reductions during economic downturns. Two new pay approaches--skill-based pay and group variable pay plans--exemplify innovations in base pay and variable pay. New approaches to indirect pay are widely popular as all companies attempt to contain their benefit costs. In order to implement new pay systems, companies should take the following steps: clarify their compensation goals, assess the company culture, start a partnership between the organization and its employees, and communicate on all levels. New pay systems will not work in all companies. (Contains 14 references.) (KC)

WORKFORCE BRIEF #5

PREPARED BY THE NATIONAL ALLIANCE OF BUSINESS

New Pay:

Compensation as a Strategic Tool

Introduction

To remain competitive, workplaces are implementing a variety of changes: self-managing units have job boundaries that cut across traditional organizational lines, empowered workers with broad and varied knowledge are actively participating in organizational decision making, and new production methods are resulting in a greater variety of low-volume customized products.

While the work companies do and how they do it have shifted significantly, companies' reward and salary structures have remained largely the same. Job classification schemes too often reinforce limited technical skills in narrowly defined jobs, piece-rate pay systems reward high-volume runs of a limited number of standard products, and many performance evaluation systems support minimal cooperation between departments.

> In a survey of 531 large and mid-sized companies, 91% reported making significant changes in their corporate culture, but only 47% realigned pay programs to support the changes. Respondents reported that changes are needed in salary programs (73%), short-term incentives (84%), and long-term incentives (74%). – *Hay Group*

A properly designed compensation/pay system can be a strategic tool to enhance a firm's competitiveness. New approaches to pay more closely tie pay to performance, rather than to tenure and entitlement. They encourage organizational performance and enhance a closer connection between employee and organizational goals by enabling employees to more fully share in the rewards and risks of the enterprise. Variable pay, a core element in new pay approaches, also helps companies promote long-term employment security by providing for pay reductions during economic downturns. Through variable pay, "pain" is spread throughout the organization, rather than concentrated in specific job losses.

The strategic use of compensation systems involves developing compensation programs that support the business strategy, reinforce organizational structure, and enhance the desired culture of the organization. While some companies are transforming their traditional compensation practices to support the changes in strategy, structure, and culture in the new workplace, many are not.

If you answer "yes" to these questions, you are ready for new pay!

- ☐ Do you think that your traditional pay system is not getting the job done and must be changed?
- ☐ Are you willing to move from a culture of tenure and entitlement to one of performance, empowerment, employee involvement, teamwork, and organization-employee partnership?
- ☐ Are you ready and willing to focus on the group, instead of the individual, as the unit of measurement, and on variable pay as the primary focus of your total compensation strategy?
- ☐ Are you willing to determine base pay on skills and the external labor market, rather than only on internal equity?
- ☐ Can you accept that indirect pay bears little relationship to desired performance and therefore is of secondary value to the total compensation strategy?
- ☐ Are you willing to tie pay to organizational success so that employees and the organization have a vested interest in each other's success?
- ☐ Are you willing to permit active involvement by employees in organizational issues that affect them?

This *Workforce Brief* will show that:

☐ Innovative companies are adopting new pay practices to support their workplace transformations and increase company flexibility. These new pay practices revolve around changes in base pay, variable pay, and indirect pay.

❑ Two new pay approaches – skill-based pay and group variable pay plans – exemplify innovations in base pay and variable pay. New approaches to indirect pay are widely popular, as all companies attempt to contain their benefit costs.

❑ New pay practices are not right for every company. Four simple steps can help you determine if they're right for your company and get you started using compensation as a strategic tool.

Traditional and New Approaches to Pay

Innovations in pay revolve around three key elements: base pay, variable pay, and indirect pay.

Base Pay

Base pay is the base salary or wage paid to an individual for his or her work. Base pay represents what the organization will pay to fill jobs or hire people with the proper skills.

❑ **Traditional Approach:** Base pay is established using a job evaluation methodology that establishes *internal* equity across positions in the company. A person is paid for the content of the job or the specific tasks that are performed. Labor market wage surveys on a sample of jobs are used to anchor the entire wage system to the external labor market.

❑ **New Approach:** Employees are paid base pay according to the economic, market, or strategic value that their individual jobs and skills have to the organization. *External* equity – market wage – is a driving factor. Internal equity is of concern within broad job functions. Base pay changes affect positions or individuals and reflect changes in the economics of the labor markets in which the organization elects to compete for talent. This gives management more flexibility to hire and retain people in the positions that make the greatest contributions to the firm's strategic objectives.

Variable Pay

Variable pay is any form of direct pay that is not folded into base pay and that varies according to performance. Variable pay is used to reward individual, team, business unit, and/or organizational performance results that change from performance period to performance period.

❑ **Traditional Approach:** Individual variable pay is emphasized and applied to a limited class of employees, primarily executives or upper-level managers. Piece-rate systems may be implemented at the shop floor level.

❑ **New Approach:** Coverage under variable pay plans is expanded, ideally to include all classes of employees. Group performance, rather than individual performance, becomes the basis of variable pay. This enables management to flexibly reward employees for performance that makes the organization successful and control pay costs when the organization is less successful.

Indirect Pay

Indirect pay, or benefits, include retirement and health plans, paid leave, and other miscellaneous benefits.

❑ **Traditional Approach:** Benefits surveys of competitive companies are used to determine appropriate benefits and benefit levels. The primary goal is to provide sufficient benefits to remain competitive in the labor market. This approach generally results in spending more money on employee benefits with no expectation of a measurable return on investment.

❑ **New Approach:** Analysis starts by defining the level and cost of benefits the company is willing to provide. Within these limits, the company strives to provide a basic level of employee protection and benefits, emphasizing benefits that are attractive to the organization's employees, rather than similar to those offered by other employers. The primary goal is to contain indirect pay costs through active cost management and cost sharing with employees in order to free dollars to spend on direct pay, particularly variable pay.

Compensation Trends: 1995

❑ Bonuses are expected to be given at 30% of companies this year, up from 25% last year. – *Towers Perrin*

❑ Forty-two percent of the companies responding to a compensation practices survey plan to implement performance-based alternative reward systems in the next two years. – *Wyatt Company*

❑ Almost half of companies will change their compensation program over the next two years. Profit sharing was the most popular change in 1994; for 1995, broadbanding (combining job classifications) and team pay are the most likely changes. – *Coopers & Lybrand*

New Pay Systems

Organizations that want to encourage employee performance and gain a competitive advantage through their pay systems are lessening job classifications, truncating pay structures, and terminating individual incentive pay systems. These firms are adopting innovations in both base pay (such as skill-based pay) and variable pay (such as gain sharing and profit sharing).

Base Pay: Skill-Based Pay

Skill-based pay, or pay for knowledge, compensates employees for the range, depth, and types of skills they possess. It represents one of the fastest growing innovations in compensation. A recent survey conducted by the Center for Effective Organizations shows that half of the Fortune 1000 firms are using skill-based pay with at least some of their employees, and expect to increase usage in the next two years.

The centerpiece of skill-based pay is the flexibility to link pay to a wider range of tasks and skills than is possible in a pay program that focuses only on the duties and responsibilities of a job. Skill-based pay systems provide explicit rewards for participation in training programs and skill acquisition, and thus they provide incentives for employees to acquire more knowledge.

The typical implementation of a skill-based pay system involves a number of components. These include:

❑ **Identify Skills.** A list of all needed skills in an area is generated through employee involvement in skills identification and a skill audit by a team of experts. These processes identify both the specific skills that are needed to perform the required work and the varying levels of complexity and application in these skills. (Current efforts to determine industry skill standards may provide a foundation for identifying skills.)

❑ **Create Skill Blocks.** Skills are arranged in skill blocks based on how they will be performed by employees. There are three major dimensions on which skill blocks can be created:

- ***Depth:*** Deeper knowledge and proficiency in the specific skills pertaining to one work area, e.g., learning more advanced manufacturing techniques or more machine operations in a particular area.
- ***Vertical:*** Administrative and leadership skills for upward advancement in the organization's hierarchy, e.g., learning more about production, inventory control, record keeping responsibilities, SPC analysis, leading team meetings, etc.
- ***Horizontal:*** Developing skills in other work areas in the company for lateral movement among the skilled jobs.

❑ **Establish Training Program.** A program must be developed to ensure that employees are given adequate opportunities for training and rotation. Issues to consider include skill-block sequencing, minimum and maximum completion times required for training, training materials and procedures, and the extent to which the organization will assume responsibility for providing skill-acquisition opportunities.

❑ **Establish Testing and Certification Program.** Most skill-based programs pay employees for demonstrated skill gains. Thus the system must have tests or measures to determine if an individual has learned a skill, and certification and record keeping systems to track skill acquisition.

❑ **Determine Pay Rates for Skill Levels.** The foundation of skill-based pay is paying more as employees demonstrate that they are obtaining and using more and more skills valuable to the organization. Determining the appropriate wage level can be difficult, since traditional wage setting procedures are not based on skills. However, the market value of skills in a skill-based pay program can be established by assembling skill blocks into "jobs" and comparing these to job pricing systems, or pricing skill blocks and adding up the "economic value." Whatever method is used, employee perceptions that skill-based pay is fair compared to what others outside and inside the organization receive for comparably skilled performance is critical to the plan's success.

Paying workers under a skill-based pay system for simply acquiring skills and knowledge only makes sense if the more skilled workers can be used effectively in the production process. For this reason, skill-based pay is usually implemented in concert with much larger and more profound changes in production systems that require increases in employee knowledge and skills.

New Pay Systems in Cin-Made

In 1985, Cin-Made and the United Paperworkers International Union instituted profit-sharing and pay-for-knowledge systems in the small, Cincinnati based packaging company. Contract wages were locked at 1984 levels, and a merit increase system was instituted to reward employees for attaining additional skill levels. In the first year, 18% of pre-tax operating profits were distributed to employees based on hours worked. Sales increased from $41,000 per employee in 1985 to $103,000 per employee in 1992. Over time, fixed wage costs fell as a percent of payroll. Cin-Made's average profit-sharing bonus for the last three years was 36% of base wages.

Variable Pay: Gain Sharing and Profit Sharing

Organizations that want to remain competitive must control base pay and reward performance with variable pay. Wherever practical, new variable pay plans focus on groups of employees. Two of the most common group variable pay plans follow:

Gain Sharing. Gain sharing plans pay dividends to groups of employees who are instrumental in bringing about improvements in productivity, cost, quality, and financial measures. Under a typical gain sharing plan, a base level of output and wages is determined, along with a method for valuing any improvements. In general, award distribution in gain sharing is either a common dollar amount per employee, a common percentage of base pay, or a common amount per hour worked. Some gain sharing plans reduce employees' wages if productivity or quality fall or costs rise.

Profit Sharing. Profit sharing is similar to gain sharing in that it links pay to firm performance, although in this case the outcome variable is profit rather than productivity gain. Profit sharing distributes a portion of an organization's profit to each employee, with amounts being calculated as a percentage of each employee's base pay. Distributions can be made in cash or in company stock or can be deferred in a qualified trust, the latter usually earmarked for retirement.

Implementing a poorly designed or ill-suited variable pay plan can do more harm than good because employees will inevitably receive mixed, even conflicting, messages from the organization about its values and priorities. A number of elements should be taken into consideration when designing a variable pay plan in order to avoid perceptions of exploitation and manipulation. These elements include the following:

Purpose and Eligibility. A clear purpose – be it to improve group performance, increase employee involvement, or enable pay to vary with performance – linked to the business plan, is critical to effective design and implementation. A clear statement of purpose should help identify the group(s) that will participate in the variable pay plan.

Measures. Measuring improvement is the core of new variable pay because it provides the justification for sharing money with employees. Potential improvement measures include profit, financial ratios, quality, customer satisfaction, and productivity. The measures selected will partially determine where the money will come from to fund the variable pay plan. Acceptable measures of performance should be:

- Relevant to both the organization and the employees, i.e., the organization wins measurably if goals are made, and goals are within the influence of the plan participants;
- Simple enough for the employees who participate in the plan to understand them, while still being accurate and appropriate; and
- Easily communicated, i.e., employees know what they are asked to do to earn the rewards and how they are progressing toward the rewards.

Payout. There are a number of technical questions that must be addressed regarding the payout of any reward. These include:

- How will awards be distributed once performance measures are attained?
- Over what period should performance be measured and evaluated?
- How often should awards be granted?

Both gain sharing and profit sharing require and reinforce a partnership between the organization and its employees. The partnership is solidified if there is a "win" when the plan is first implemented. This means that a variable pay plan should be practical, workable, and likely to produce positive results.

Indirect Pay

The constant increases in costs have made almost all companies advocates of new approaches to indirect pay. These approaches try to enhance the value of benefits to employees while simultaneously lowering their costs. Illustrative changes under new approaches to pay include helping employees purchase benefits on a pre-tax basis; using health maintenance organizations or preferred provider networks; allowing employees to purchase additional life insurance; establishing a single paid time off account covering sick, vacation, and holiday time; including indirect pay goals in gain sharing plans (e.g., savings in sick and disability days); and establishing flexible benefit plans

Skill-Based Pay in an Automotive Components Supplier

In establishing its skill-based pay system, a joint labor-management steering committee at an automotive components supplier identified 17 non-exempt occupational areas and designed skill blocks for each. The number of advancement opportunities in the design varies from two levels for security guards and supply room attendants to five levels for jobs in the press and machine maintenance departments. The company certifies five types of skills within each work area skill block: quality, cost, delivery, morale, and safety. Skills are certified through demonstrations, interviews, and/or record reviews. A review team consisting of a work area leader, individuals from the next two levels of management, and a work area peer observes and assesses demonstrations of skill proficiency. Employees must wait 12 months between applications for certification at an additional skill level.

that allow employees to select the benefits of most value to them.

Steps Toward New Pay

Compensation strategies should support and enhance organizational change. Attempts to improve performance simply by manipulating compensation packages have proven counterproductive. However, reorganizing work processes to capitalize on employee skills and participation has improved performance, especially when combined with employment security, gain sharing, and incentives to take part in training. Although new approaches to pay are not likely to be the only factor that will help move a company toward a more positive future, they are clearly the only way to make employee pay a constructive catalyst for this change. Four steps can start you on your way to using compensation as a strategic tool:

✔ **Clarify Your Compensation Goals.** Organizations that decide to implement a new pay plan need to be clear about the goals and expectations for the program.

Top management, in particular, should provide a clear statement delineating the appropriateness of new pay approaches to the business direction and goals of the organization. Managers should articulate how new pay plans contribute to ongoing organizational changes, reinforce specific short-and long-term company goals, and/or help ensure a strong customer focus.

The various elements of new pay systems should be put together in ways that are appropriate to your company. There is no set package of elements and no fixed schedule for implementing a new pay system.

Harford Systems, Duracool Division, Gain Sharing Plan

The Harford gain sharing plan was designed by a cross section of employees from all levels in the plant. Each month, actual performance is calculated based on performance levels for productivity, quality, safety, and finance. Net performance change from an existing baseline is used to establish the dollar value added to the employee pool. (Fifty percent of the performance improvement goes to the company and 50% to the employees.) A 20% reserve is deducted from the employee pool to cover payout if performance is up but profits are down, and the balance is paid out. The payout is distributed quarterly. Each participating employee receives the same dollar amount and everyone, except the president, participates in the plan after a minimum tenure at the company.

✔ **Assess Your Company Culture.** New approaches to pay create a partnership between the organization and its employees, a partnership that requires increased levels of employee participation, involvement in decisions, and empowerment to affect the work environment. Employee readiness and a culture supportive of employee involvement are critical to establishing this partnership. To determine an organization's readiness for new approaches to pay (or to identify what must be done to facilitate new pay systems), look at the levels of:

- Communication (upward, downward, and horizontally) within the organization.
- Employee understanding and support of the mission, goals, and objectives of the organization.
- Belief that employees themselves improve productivity, quality, and results,
- Teamwork and collaboration within the organization,
- Employee trust in management, and
- Employee understanding of how the organization's products or services fit into the market and are perceived and used by the customer.

The greater the understanding, support, and teamwork, the more easily a partnership can be formed and employees can help the organization be successful.

✔ **Start a Partnership.** The new view of pay provides that organizations effectively use all elements of pay to form a partnership between the organization and its employees. Through this partnership, employees can understand the goals of the organization, know where they fit in accomplishing these goals, become appropriately involved in decisions affecting their contribution to the goals, and receive rewards to the extent that they help the organization attain the goals. A good way to begin this partnership is to form an employee-management task force, with employees selecting tr. ir representatives, to design the new pay system.

In a unionized work setting, it is important to engage the labor organization as a partner, recognizing the legitimate role of the union leadership as a change agent. The collective bargaining agreement serves as the basis for any examination of compensation and benefits, and any changes in compensation and benefits must be negotiated through the collective bargaining process.

✔ **Communicate.** Communication must occur on at least three fronts. Top management must clarify how the change in pay fits into the organization's mission, strategies, and goals, and must demonstrate support for the change. The new pay system development task force must communicate the design of the new program, answer questions, and support the change. Employees' supervisors must ensure that employees understand the change and lead employees to accept the program and work toward achieving the program's goals.

Research Results: Variable Pay

- ❑ Firms that introduced a specific gain sharing plan demonstrated an average cumulative productivity improvement of 15% three years after initial implementation, compared with an average 6% increase in comparable manufacturing firms without gain sharing. -- *Kaufman, 1992.*
- ❑ The U.S. General Accounting Office found that those firms with gain sharing plans in place for more than five years averaged an annual 29% reduction in labor costs.
- ❑ A review of 27 formal econometrics studies found that the use of profit sharing was generally associated with 3.5 to 5% higher productivity, measured through value added or sales per employee. The productivity increase for small and mid-sized firms was over 11%. The estimated effects also were greater for plans in firms where payouts were more generous and were made immediately. – *Kruse, 1994.*
- ❑ Forty-four percent of 432 compensation plans examined in one study showed gains from profit sharing. The annual gains per employee reported ranged from $370 to $8,880, with an average return of $1.34 for every dollar invested (34% return). – *American Compensation Association.*

Further information on the issues presented in this brief can be obtained from:

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– Stephen Mitchell, 1995

The ***National Workforce Assistance Collaborative*** builds the capacity of the service providers working with small and mid-sized companies in order to help businesses adopt high-performance work practices, become more competitive, and ultimately advance the well-being of their employees. The Collaborative was created with a $650,000 cooperative agreement grant from the ***Department of Labor*** to the ***National Alliance of Business***. Current partners on the project include the Council for Adult and Experiential Learning, the Institute for the Study of Adult Literacy at Pennsylvania State University, the Maryland Center for Quality and Productivity, and the National Labor-Management Association. The Collaborative provides assistance in four areas: employee training, labor-management relations, work restructuring, and workplace literacy. For more information, contact Bernice Jones at the National Alliance of Business (202) 289-2915.

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