

Compensation

Eleventh Edition

George T. Milkovich

Cornell University

Jerry M. Newman

*State University of New York–
Buffalo*

Barry Gerhart

University of Wisconsin–Madison

 **McGraw-Hill
Irwin**

Table of Contents

Preface xiii

PART ONE

INTRODUCING THE PAY MODEL AND PAY STRATEGY

Chapter 1

The Pay Model 3

Compensation: Does It Matter? (or, “So What?”) 4

Compensation: Definition, Please 5

Society 5

Stockholders 7

Managers 9

Employees 11

Incentive and Sorting Effects of Pay on Employer’s

Behaviors 11

Global Views—Vive la Différence 12

Forms of Pay 13

Cash Compensation: Base 14

Cash Compensation: Merit Pay/Cost-of-Living Adjustments 14

Cash Compensation: Incentives 15

Long-Term Incentives 15

Benefits: Income Protection 16

Benefits: Work/Life Balance 16

Benefits: Allowances 16

Total Earnings Opportunities: Present Value of a Stream of Earnings 17

Relational Returns from Work 17

A Pay Model 18

Compensation Objectives 19

Four Policy Choices 21

Pay Techniques 23

Book Plan 24

Caveat Emptor—Be an Informed Consumer 25

1. Is the Research Useful? 25

2. Does the Study Separate Correlation from Causation? 26

3. Are There Alternative Explanations? 26

Your Turn: The Role of Labor Costs in the Retail Electronics and Airline Industries 27

Chapter 2

Strategy: The Totality of Decisions 38

Similarities and Differences in Strategies 38

Different Strategies within the Same Industry 41

Different Strategies within the Same Company 41

Strategic Choices 42

Support Business Strategy 43

Support HR Strategy 45

The Pay Model Guides Strategic Pay Decisions 46

Stated versus Unstated Strategies 47

Developing a Total Compensation Strategy:

Four Steps 48

Step 1: Assess Total Compensation Implications 49

HR Strategy: Pay as a Supporting Player or

Catalyst for Change? 49

Step 2: Map a Total Compensation Strategy 52

Steps 3 and 4: Implement and Reassess 55

Source of Competitive Advantage: Three Tests 55

Align 55

Differentiate 55

Add Value 56

“Best Practices” versus “Best Fit”? 57

Guidance from the Evidence 57

Virtuous and Vicious Circles 58

Your Turn: Merrill Lynch 59

Still Your Turn: Mapping Compensation

Strategies 61

PART TWO

INTERNAL ALIGNMENT:

DETERMINING THE STRUCTURE

Chapter 3

Defining Internal Alignment 71

Jobs and Compensation 72

Compensation Strategy: Internal Alignment 72
 Supports Organization Strategy 73
 Supports Work Flow 73
 Motivates Behavior 74

Structures Vary among Organizations 74
 Number of Levels 75
 Differentials 75
 Criteria: Content and Value 75

What Shapes Internal Structures? 78
 Economic Pressures 78
 Government Policies, Laws, and Regulations 79
 External Stakeholders 79
 Cultures and Customs 80
 Organization Strategy 80
 Organization Human Capital 81
 Organization Work Design 81
 Overall HR Policies 81
 Internal Labor Markets: Combining External and Organization Factors 82
 Employee Acceptance: A Key Factor 83
 Pay Structures Change 83

Strategic Choices in Designing Internal Structures 84
 Tailored versus Loosely Coupled 84
 Hierarchical versus Egalitarian 84

Guidance from the Evidence 86
 Equity Theory: Fairness 86
 Tournament Theory: Motivation and Performance 88
 Institutional Model: Copy Others 89
 (More) Guidance from the Evidence 90

Consequences of Structures 91
 Efficiency 91
 Fairness 91
 Compliance 91

Your Turn: So You Want to Lead an Orchestra! 92
Still Your Turn: (If You Don't Want to Lead the Orchestra . . .) 93

Chapter 4
Job Analysis 100

Structures Based on Jobs, People, or Both 101
Job-Based Approach: Most Common 103
 Why Perform Job Analysis? 103

Job Analysis Procedures 104
What Information Should Be Collected? 105
 Job Data: Identification 105
 Job Data: Content 105
 Employee Data 107
 "Essential Elements" and the Americans With Disabilities Act 110
 Level of Analysis 111

How Can the Information Be Collected? 112
 Conventional Methods 112
 Quantitative Methods 112
 Who Collects the Information? 114
 Who Provides the Information? 114
 What about Discrepancies? 115

Job Descriptions Summarize the Data 116
 Using Generic Job Descriptions 116
 Describing Managerial/Professional Jobs 116
 Verify the Description 117

Job Analysis: Bedrock or Bureaucracy? 119

Job Analysis and Globalization 120
 Job Analysis and Susceptibility to Offshoring 120
 Job Analysis Information and Comparability across Borders 122

Judging Job Analysis 122
 Reliability 122
 Validity 123
 Acceptability 123
 Currency 123
 Usefulness 123
 A Judgment Call 124

Your Turn: The Customer-Service Agent 125

Chapter 5
Job-Based Structures and Job Evaluation 134

Job-Based Structures: Job Evaluation 135
Defining Job Evaluation: Content, Value, and External Market Links 136
 Content and Value 136
 Linking Content with the External Market 136
 Technical and Process Dimensions 137

"How-To": Major Decisions 137
 Establish the Purpose 138
 Single versus Multiple Plans 138

<i>Choose among Job Evaluation Methods</i>	140
Job Evaluation Methods	141
<i>Ranking</i>	141
<i>Classification</i>	142
<i>Point Method</i>	144
Who Should Be Involved?	155
<i>The Design Process Matters</i>	156
The Final Result: Structure	157
Balancing Chaos and Control	158
<i>Your Turn: Job Evaluation at</i>	
Whole Foods	159

Chapter 6

Person-Based Structures 167

Person-Based Structures: Skill Plans	168
<i>Types of Skill Plans</i>	168
<i>Purpose of the Skill-Based Structure</i>	171
“How-To”: Skill Analysis	172
<i>What Information to Collect?</i>	172
<i>Whom to Involve?</i>	173
<i>Establish Certification Methods</i>	173
<i>Outcomes of Skill-Based Pay Plans: Guidance from</i>	
<i>Research and Experience</i>	175
Person-Based Structures: Competencies	176
<i>Defining Competencies</i>	179
<i>Purpose of the Competency-Based</i>	
<i>Structure</i>	180
“How-To”: Competency Analysis	181
<i>Objective</i>	182
<i>What Information to Collect?</i>	182
<i>Whom to Involve?</i>	184
<i>Establish Certification Methods</i>	185
<i>Resulting Structure</i>	185
<i>Competencies and Employee Selection and</i>	
<i>Training/Development</i>	185
<i>Guidance from the Research on</i>	
<i>Competencies</i>	187
One More Time: Internal Alignment Reflected in	
Structures (Person-Based or Job-Based)	187
Administering and Evaluating the Plan	189
<i>Reliability of Job Evaluation Techniques</i>	189
<i>Validity</i>	191
<i>Acceptability</i>	192
Bias in Internal Structures	192
<i>Wages Criteria Bias</i>	193

The Perfect Structure	194
<i>Your Turn: Climb the Legal Ladder</i>	195

PART THREE

EXTERNAL COMPETITIVENESS: DETERMINING THE PAY LEVEL

Chapter 7

Defining Competitiveness 207

Compensation Strategy: External	
Competitiveness	208
<i>Control Costs and Increase Revenues</i>	208
<i>Attract and Retain the Right Employees</i>	210
What Shapes External Competitiveness?	213
Labor Market Factors	213
<i>How Labor Markets Work</i>	215
<i>Labor Demand</i>	216
<i>Marginal Product</i>	216
<i>Marginal Revenue</i>	217
<i>Labor Supply</i>	218
Modifications to the Demand Side	218
<i>Compensating Differentials</i>	219
<i>Efficiency Wage</i>	220
<i>Sorting and Signaling</i>	221
Modifications to the Supply Side (Only Two	
More Theories to Go)	222
<i>Reservation Wage</i>	222
<i>Human Capital</i>	223
Product Market Factors and Ability	
to Pay	223
<i>Product Demand</i>	223
<i>Degree of Competition</i>	224
<i>A Different View: What Managers Say</i>	224
<i>Segmented Supplies of Labor and (Different)</i>	
<i>Going Rates</i>	225
Organization Factors	226
<i>Industry and Technology</i>	226
<i>Employer Size</i>	226
<i>People’s Preferences</i>	227
<i>Organization Strategy</i>	227
Relevant Markets	228
<i>Defining the Relevant Market</i>	228
<i>Globalization of Relevant Labor Markets:</i>	
<i>Offshoring and Outsourcing</i>	229

Competitive Pay Policy Alternatives 232
 What Difference Does the Pay-Level Policy Make? 232
 Pay with Competition (Match) 232
 Lead Pay-Level Policy 234
 Lag Pay-Level Policy 234
 Different Policies for Different Employee Groups 235
 Not by Pay Level Alone: Pay-Mix Strategies 235
Consequences of Pay-Level and -Mix Decisions:
Guidance from the Research 240
 Efficiency 240
 Fairness 241
 Compliance 241
Your Turn: Two-Tier Wages 242

Appendix

7-A: Utility Analysis 244

Chapter 8

Designing Pay Levels, Mix, and Pay Structures 252

Major Decisions 253
Specify Competitive Pay Policy 253
The Purpose of a Survey 254
 Adjust Pay Level—How Much to Pay? 254
 Adjust Pay Mix—What Forms? 254
 Adjust Pay Structure? 254
 Study Special Situations 255
 Estimate Competitors' Labor Costs 255
Select Relevant Market Competitors 255
 Fuzzy Markets 259
Design the Survey 260
 Who Should Be Involved? 260
 How Many Employers? 260
 Which Jobs to Include? 263
 What Information to Collect? 265
Interpret Survey Results and Construct a Market Line 268
 Verify Data 269
 Statistical Analysis 274
 Update the Survey Data 276
 Construct a Market Pay Line 276
 Setting Pay for Benchmark and Non-Benchmark Jobs 278
 Combine Internal Structure and External Market Rates 280

From Policy to Practice: The Pay-Policy Line 281
 Choice of Measure 281
 Updating 281
 Policy Line as Percent of Market Line 282
From Policy to Practice: Grades and Ranges 282
 Why Bother with Grades and Ranges? 282
 Develop Grades 283
 Establish Range Midpoints, Minimums, and Maximums 283
 Overlap 284
From Policy to Practice: Broad Banding 285
 Flexibility-Control 287
Balancing Internal and External Pressures:
Adjusting the Pay Structure 288
 Reconciling Differences 288
Market Pricing 288
 Business Strategy (More Than “Follow the Leader”) 289
Review 290
Your Turn: Google Evolving Pay Strategy 291
Still Your Turn: Word-of-Mouse: Dot-Com Comparisons 292

PART FOUR

EMPLOYEE CONTRIBUTIONS: DETERMINING INDIVIDUAL PAY

Chapter 9

Pay-for-Performance: The Evidence 302

What Behaviors Do Employers Care About?
Linking Organization Strategy to Compensation and Performance Management 303
What Does It Take to Get These Behaviors? What Theory Says 308
What Does It Take to Get These Behaviors? What Practitioners Say 312
Does Compensation Motivate Behavior? 317
 Do People Join a Firm Because of Pay? 317
 Do People Stay in a Firm (or Leave) Because of Pay? 318
 Do Employees More Readily Agree to Develop Job Skills Because of Pay? 319
 Do Employees Perform Better on Their Jobs Because of Pay? 319

Designing a Pay-for-Performance Plan 323

Efficiency 323

Equity/Fairness 324

Compliance 325

Your Turn: Burger Boy 325

Chapter 10

Pay-for-Performance Plans 335

What Is a Pay-for-Performance Plan? 335

Does Variable Pay Improve Performance Results?

The General Evidence 337

Specific Pay-for-Performance Plans:

Short Term 337

Merit Pay 337

Lump-Sum Bonuses 338

Individual Spot Awards 340

Individual Incentive Plans 340

Individual Incentive Plans: Advantages and Disadvantages 343

Individual Incentive Plans: Examples 344

Team Incentive Plans: Types 345

Comparing Group and Individual Incentive Plans 351

Large Group Incentive Plans 352

Gain-Sharing Plans 352

Profit-Sharing Plans 357

Earnings-at-Risk Plans 358

Group Incentive Plans: Advantages and Disadvantages 359

Group Incentive Plans: Examples 360

Explosive Interest in Long-Term Incentive Plans 360

Employee Stock Ownership Plans (ESOPs) 362

Performance Plans (Performance Share and Performance Unit) 363

Broad-Based Option Plans (BBOPs) 363

Combination Plans: Mixing Individual and Group 363

Your Turn: Incentives Can Be too

Powerful 364

Appendix

10-A: Profit-Sharing (401K) at Walgreens 366

Chapter 11

Performance Appraisals 371

The Role of Performance Appraisals in Compensation Decisions 372

Performance Metrics 373

Strategies for Better Understanding and Measuring Job Performance 374

The Balanced Scorecard Approach 375

Strategy 1: Improve Appraisal Formats 375

Strategy 2: Select the Right Raters 384

Strategy 3: Understand How Raters Process Information 386

Strategy 4: Training Raters to Rate More Accurately 390

Putting It All Together: The Performance Evaluation Process 391

Equal Employment Opportunity and Performance Evaluation 392

Tying Pay to Subjectively Appraised Performance 396

Competency: Customer Care 397

Performance- and Position-Based Guidelines 398

Designing Merit Guidelines 398

Promotional Increases as a Pay-for-Performance Tool 401

Your Turn: Performance Appraisal at Burger King 401

Appendix

11-A: Balanced Scorecard Example: Department of Energy (Federal Personal Property Management Program) 405

11-B: Sample Appraisal Form for Leadership Dimension: Pfizer Pharmaceutical 408

PART FIVE

EMPLOYEE BENEFITS

Chapter 12

The Benefit Determination Process 428

Why the Growth in Employee Benefits? 430

Wage and Price Controls 430

viii *Table of Contents*

Unions 430
Employer Impetus 430
Cost Effectiveness of Benefits 431
Government Impetus 431
The Value of Employee Benefits 431
Key Issues in Benefit Planning, Design, and Administration 433
Benefits Planning and Design Issues 433
Benefit Administration Issues 434
Components of a Benefit Plan 437
Employer Preferences 437
Employee Preferences 440
Administering the Benefit Program 443
Employee Benefit Communication 443
Claims Processing 446
Cost Containment 446
Your Turn: World Measurement 447

Chapter 13
Benefit Options 455

Legally Required Benefits 458
Workers' Compensation 459
Social Security 460
Unemployment Insurance 463
Family and Medical Leave Act (FMLA) 465
Consolidated Omnibus Budget Reconciliation Act (COBRA) 465
Health Insurance Portability and Accountability Act (HIPAA) 465
Retirement and Savings Plan Payments 465
Defined Benefit Plans 466
Defined Contribution Plans 466
Individual Retirement Accounts (IRAs) 468
Employee Retirement Income Security Act (ERISA) 468
How Much Retirement Income to Provide? 470
Life Insurance 471
Medical and Medically Related Payments 471
General Health Care 471
Health Care: Cost Control Strategies 475
Short- and Long-Term Disability 476

Dental Insurance 477
Vision Care 477
Miscellaneous Benefits 478
Paid Time Off During Working Hours 478
Payment for Time Not Worked 478
Child Care 479
Elder Care 479
Domestic Partner Benefits 479
Legal Insurance 479
Benefits for Contingent Workers 480
Your Turn: Adapting Benefits to a Changing Strategy 480

PART SIX
EXTENDING THE SYSTEM

Chapter 14
Compensation of Special Groups 487

Who Are Special Groups? 488
Compensation Strategy for Special Groups 488
Supervisors 488
Corporate Directors 489
Executives 490
What's All the Furor over Executive Compensation? What the Critics and Press Say 495
What's All the Furor over Executive Compensation? What Academics Say 499
Scientists and Engineers in High-Technology Industries 501
Sales Forces 505
Contingent Workers 509
Your Turn: A Sports Sales Plan 510

Chapter 15
Union Role in Wage and Salary Administration 517

The Impact of Unions in Wage Determination 518
Union Impact on General Wage Levels 519
The Structure of Wage Packages 521
Union Impact: The Spillover Effect 522
Role of Unions in Wage and Salary Policies and Practices 522

Unions and Alternative Reward Systems	527
<i>Lump-Sum Awards</i>	527
<i>Employee Stock Ownership Plans (ESOPs)</i>	527
<i>Pay-for-Knowledge Plans</i>	527
<i>Gain-Sharing Plans</i>	528
<i>Profit-Sharing Plans</i>	528
<i>Your Turn: Predicting a Contract's</i>	
<i>Clauses</i>	529

Chapter 16

International Pay Systems 534

The Global Context	536
The Social Contract	538
<i>Centralized or Decentralized</i>	
<i>Pay-Setting</i>	539
<i>Regulation</i>	540
Culture	543
<i>Culture Matters, but So Does Cultural</i>	
<i>Diversity</i>	545
Trade Unions and Employee Involvement	547
Ownership and Financial Markets	547
Managerial Autonomy	548
Comparing Costs	549
<i>Labor Costs and Productivity</i>	549
<i>Cost of Living and Purchasing Power</i>	552
Comparing Systems	555
<i>The Total Pay Model: Strategic Choices</i>	555
National Systems: Comparative Mind-Set	555
<i>Japanese Traditional National System</i>	555
<i>German Traditional National System</i>	559
<i>Strategic Comparisons: Traditional Systems in</i>	
<i>Japan, Germany, United States</i>	560
<i>Evolution and Change in the Traditional Japanese</i>	
<i>and German Models</i>	562
Strategic Market Mind-Set	564
<i>Localizer: "Think Global, Act Local"</i>	564
<i>Exporter: "Headquarters Knows Best"</i>	564
<i>Globalizer: "Think and Act Globally and</i>	
<i>Locally"</i>	565
Expatriate Pay	565
<i>Elements of Expatriate Compensation</i>	567
<i>The Balance Sheet Approach</i>	569
<i>Expatriate Systems → Objectives? Quel</i>	
<i>dommage!</i>	573

Borderless World → Borderless Pay?	
Globalists	574
<i>Your Turn: IBM's Worldwide Business and</i>	
<i>Employment Strategies and Compensation</i>	574

PART SEVEN

MANAGING THE SYSTEM

Chapter 17

Government and Legal Issues in Compensation 591

Government as Part of the Employment	
Relationship	593
<i>Demand</i>	593
<i>Supply</i>	593
Fair Labor Standards Act of 1938	596
<i>Minimum Wage</i>	597
<i>Overtime and Hours of Work</i>	599
<i>Child Labor</i>	604
Living Wage	604
Employee or Independent Contractor?	605
Prevailing Wage Laws	608
Pay Discrimination: What Is It?	608
The Equal Pay Act	610
<i>Definition of Equal</i>	611
<i>Definitions of Skill, Effort, Responsibility, Working</i>	
<i>Conditions</i>	611
<i>Factors Other Than Sex</i>	612
<i>"Reverse" Discrimination</i>	612
Title VII of the Civil Rights Act of 1964 and	
Related Laws	613
<i>Disparate Treatment</i>	614
<i>Disparate Impact</i>	614
Executive Order 11246	614
Pay Discrimination and Dissimilar Jobs	617
<i>Evidence of Discrimination: Use of</i>	
<i>Market Data</i>	617
<i>Evidence of Discrimination: Jobs of Comparable</i>	
<i>Worth</i>	618
Earnings Gaps	618
<i>Sources of the Earnings Gaps</i>	620
<i>Differences in Occupations and</i>	
<i>Qualifications</i>	620

x *Table of Contents*

Differences in Industries and Firms 623
Union Membership 624
Presence of Discrimination 624
Gaps Are Global 625
Comparable Worth 625
The Mechanics 626
Union Developments 627
Compliance: A Proactive Approach 628
Your Turn: Self-Evaluation and Pay
Discrimination 628
Still Your Turn: From Barista to Manager 629
Still (yes, still) Your Turn: “I Was Gaga’s Slave” 630

Chapter 18

Management: Making It Work 640

Managing, Controlling (and Sometimes
Reducing) Labor Costs 641
*Number of Employees (a.k.a.: Staffing Levels or
Headcount)* 642
Hours 646
Controlling Benefits 646
Controlling Average Cash Compensation 647
Control Salary Level: Top Down 648
Current Year’s Rise 648
Ability to Pay 648
Competitive Market Pressures 649
Turnover Effects 649
Cost of Living 649
Rolling It All Together 651

Control Salary Level: Bottom Up 652
Ethics: Managing or Manipulating? 653
Where Is the Compensation Professional? 654
Embedded Controls 654
Range Maximums and Minimums 654
Promotions and External versus Internal Hires 655
Compa-Ratios 655
Variable Pay 656
Analyzing Costs 656
Analyzing Value Added 657
Communication: Managing the Message 659
Say What? (Or, What to Say?) 664
Pay as Change Agent 665
Structuring the Compensation Function 666
Centralization—Decentralization 666
*Flexibility within Corporatewide
Principles* 667
Reengineering and Outsourcing 667
Balancing Flexibility and Control 668
Your Turn: Communication by Copier 669
*Still Your Turn: Managing Compensation Costs,
Headcount, and Participation/Communication
Issues* 669

Glossary 675

Name Index 694

Subject Index 706