PART I

HOW HARD CAN THIS BE?

ONE

Common Sense, Economics, and HR

How to Pay

Billions of people throughout the world are paid for their work. This book was written to demonstrate why they earn what they earn and, in doing so, to help them understand how they can earn more in the short run and even more in the longer run. There are many ways pay is determined across a wide variety of organizations, from for-profit firms, to nonprofit organizations, to government agencies. By the time you finish reading this book, you will know how a well-run organization takes its overall strategy and converts that into a system for properly paying people. Then you can apply the lessons in the book to your own organization and take actions that can lead you to earn more.

But how difficult can this be? All we are trying to do is consider how and why people are paid the way they are paid. It turns out that this *is* difficult, but I will try to show you why firms and other organizations do what they do, and with this help, you will hopefully understand how you may be able to better navigate work and consider some things you can do to earn more. Many firms set pay on an ad hoc basis and, frankly, they don't really know what they are doing. Many others have sophisticated systems in place for how to set pay within their organizations. There are many variants to this latter approach, and I highlight these as we go through a basic system that is essentially used by most organizations.

Still other firms have unionized workplaces where wages, benefits, and working conditions are negotiated with labor unions. In addition, some people work for the government and have a set of pay scales that are determined in yet another way. The bulk of this book focuses on what many large employers do. What these companies do is important because it trickles down to many of the rest of the organizations that follow the lead. It is also the case that many of the lessons learned from the "standard" case are applied in unionized, nonprofit, and government settings. In any event, I stress the "standard" case but also point out these other special cases as we go along.

Consider two jobs and how you might best design a pay system for them: professional cucumber (pickle) picker and chief executive officer (CEO). What is the "right" *level* of pay for these occupations? Separately, *how* should each of these occupations be paid? Consider the simple example I first use every time I teach compensation to students, both undergraduate and graduate, as well as compensation practitioners and executives. I picked cucumbers on a small farm for four years when I was growing up. You probably don't know many professional cucumber pickers, but think for a minute about how much they should be paid. Ten dollars an hour? More? Less? Perhaps they should be paid a "market" wage – but what market? How is this determined? We will get to this as we go along.

A much more interesting question is *how* (relative to how much) to pay the pickers? Should they be paid by the pound? This makes sense on the surface, but "big" cucumbers are really not worth very much at all, especially relative to smaller cucumbers that can be made into pickles. Further, counting how many of each type each person picks is a demanding and expensive process that may not be worth the trouble. Another problem with paying by the pound is that workers might suffer too much risk from this. For example, when there is no rain for a period of time, the cucumber vines dry up and produce very few cucumbers, and if workers are paid by the pound then they don't earn much money. We will discuss later why it might be better for the company, rather than individual workers, to take on this risk.

It turns out that cucumber picking is much more complicated than it sounds: *institutions* matter and how the cucumbers are picked matters. Designing an effective compensation plan for cucumber pickers requires careful and clear knowledge of how cucumbers are picked. This is true when considering pay in *all* occupations. We will go into this in more depth later, but it turns out that professional cucumber pickers are largely paid by the hour.

Consider CEOs next. Some people think CEOs are paid too much. Why? They are paid way more than most of us, but is it too much? How is their pay determined? Is it a "real" labor market or, as some have suggested, is this a market that is not efficient and CEOs gain at the expense of others? Should CEOs be paid by the hour? Would it be better to motivate them and pay them by some sort of "piece rate" (similar to paying by the cucumber)? The piece rate for CEOs could be a measure of profitability, sales, or stock price. It turns out that these objective metrics are easier to measure than cucumbers but they may not always be the things you want CEOs to respond to. In the end, CEOs are typically paid partly for their time (salary) and partly for certain other measures of performance. This is not to say that they are paid correctly, and we will cover more of this as we go along.

One problem with the way firms pay is that it isn't always clear that they know the way they are paying is the right way to pay. Consider one set of companies (A) that pays its employees only in cash (salaries). Consider another set (B) that pays only in equity (stock and stock options). Further suppose that the companies in set A are less profitable than those in set B. Does this mean that it is better for the shareholders or owners of a given company to pay in stock and stock options? Maybe, but there is no way to know with the information I have provided you. Just because a particular Human Resource (HR) practice (e.g., paying mostly in salary) is associated with one set of firms and another practice (e.g., paying mostly in equity) is associated with another set of firms doesn't mean that either HR practice had an effect on profits. Maybe more profitable firms can afford to pay a certain way and the causality actually goes in reverse. It turns out that we could test this by having firms switch from one HR practice (e.g., switching from one form of pay to another) and observing what happens. But this is very hard to do in practice. Most managers don't have the time, energy, or resources to see what works best. They typically have to make a decision and move on. In many cases they pick a practice, declare "victory," and move on to the next issue, but they never *really* know if the practice "worked." Organizations can do more to learn about how to make themselves and their employees better off.

Another big issue is organization strategy and the difficulties it imposes. Imagine having to think about how to pay the CEOs of Bristol Meyers Squibb (BMS) and of Tupperware. Tupperware, among other things, designs and manufactures plastic products. These products can go from concept to consumer relatively quickly. Paying a CEO of Tupperware in a relatively short-term way (e.g., in part in an annual bonus) might make some sense. On the other hand, the time lag from concept to consumer in a company like BMS can be many, many years. Therefore, heavily relying on short-term bonuses may not make much sense. To make this even more complicated, certain BMS rivals – Astra-Zeneca (the British pharmaceutical company), for example – may also want to pay its CEO and other employees differently for competitive reasons of their own.

The rest of the book discusses some details about pay levels and differences in society and then discusses how organizations start with an organizational strategy, translate that into a compensation strategy, and, in turn, translate that into a pay system. It then goes on to discuss some suggestions for earning more in the short term and others that will lead to financial payoffs in the future.

Chapter 2 is about wages, the wage distribution, and wage inequality. This begins with a simple discussion of compensation differences. There have been dramatic differences in levels of pay between men and women, African Americans and others, the young and others, and many other groups. I discuss whether and why this is changing. This chapter goes on to discuss the extraordinarily wide distribution of income in the world and in the United States in particular. I discuss reasons for this dramatic level of income inequality and whether it is likely to change in the near future.

Chapter 3 discusses who makes what and their characteristics. This includes a list of occupations and a discussion of the level of compensation and benefits in those jobs, as well as the characteristics of people holding those jobs, including, among others, age, education, gender, levels of experience, and average seniority on the job.

Chapter 4 asks a simple but very rarely considered question: Is there a difference between the cost of compensation to organizations and the value of that compensation to employees? This idea is introduced by showing the wide disparity between cash compensation and the variety of benefits that employees earn. There is also wide diversity in the kinds of benefits employees receive. In fact, only about 70 cents for every dollar paid by organizations goes directly into the pockets of workers.

Part II of the book is mostly focused on how and why firms set their pay structure. This includes a discussion of the mechanics of how most large companies set pay. Chapter 5 discusses why where you work matters a lot. This includes a discussion of why it is important that an organization's business strategy and compensation strategy are linked and what the implications of that are for workers. Chapter 6 tackles job analysis, job evaluation, and internal comparisons. Job analysis is, in some sense, a description of jobs – even breaking jobs down into their most mundane and simple tasks. Jobs are then rated across a number of features to come up with "scores" across a variety of characteristics. In a second step, jobs are "evaluated" and scored by essentially rating them in a variety of dimensions along what are known as "compensable" factors. I was skeptical of this when I first learned about it, but this makes sense – rather than making subjective judgments about jobs, this type of system requires people to be explicit about what matters and how jobs are in some sense "ranked." Note that neither Chapter 5 nor Chapter 6 examines compensation at all. They simply discuss what was done in each occupation and the relative value of those jobs to *the organization in question.*

Chapter 6 continues with a discussion of internal comparisons. Internal comparisons of compensation are extremely difficult, but it is essential for organizations to consider carefully the relative value of each position in the company. If an organization does not make these kinds of difficult decisions early, then it will lead to arbitrary and capricious compensation decisions later. This can also lead to employee dissatisfaction and lawsuits. Having managers and employees truly understand how they are paid is very important.

In Chapter 7, I discuss the importance of collecting the right comparison data and matching the internal structure to external market data. If organizations do not make comparisons to the appropriate competitor firms, then much of the rest of the work discussed here is for naught. In this chapter, I show how we can take the internal structure developed in Chapters 5 and 6 and match that with data external to the firm (typically purchased from compensation consulting firms). In this step, the "benchmark" jobs that we focused on in Chapters 5 and 6 are individually matched with "benchmark jobs" from the consultants' data. This combination of internal work and data on jobs and external data on compensation levels for similar kinds of jobs forms the basis for the internal pay structure of the company. In this, we will see how companies with different strategies (e.g., BMS and Astra-Zeneca) may both optimally pay similar workers (e.g., salespeople) in different ways, even though both companies are in the same industry.

Paying people at the very high end of the compensation scale has a unique set of issues and problems. Chapter 8 focuses on the highly paid. Although there is discussion of athletes, entertainers, and other "superstars," the primary focus in this chapter is on executives, with particular emphasis on CEOs of publicly traded for-profit companies. This is not just a "trendy" issue that has come out of the recent financial crises; there has been scrutiny of the pay packages of CEOs for decades.

As I noted earlier, trying to determine *how* people are paid can be as (or more) important as *how much* they are paid. Part III is devoted to these and other issues. It begins with Chapter 9, which outlines the problems and difficulties of evaluating performance, as well as circumstances where incentive pay can be very useful and helpful, and others where providing incentives to workers can lead to unintended consequences and negative outcomes.

A large number of people, not just executives, are being paid in equity (stock and stock options). Chapter 10 describes stock and stock options and offers a guide to where they are and are not useful as a way to pay people. Equity compensation can have important incentive and retention value. But there are problems with equity pay, including the fact that some forms of equity are difficult for employees to understand and value, and there are important and changing accounting and tax consequences of equity compensation.

Although I don't really think of "pay" and "benefits" as separate subjects, the "mix" of pay and the interesting question of why employers offer any benefits rather than just pay workers cash are the subject of Chapter 11. Why not just pay cash and let the workers choose which benefits they want to purchase with their money? In addition to the obvious tax reasons for offering certain benefits (e.g., health insurance in the United States), many employers offer unique benefits. For example, Cornell University pays one-half of Cornell's tuition for each of my children if they attend Cornell and 30 percent of tuition if they attend some other college or university. Would I be better off with the cash equivalent to do what I want? What about my colleagues who don't have kids? They are essentially being paid less.

Surprisingly little is known about international compensation. In a recent meeting I had with a group of international compensation executives, we were all surprised at how much variability there was in answers with respect to basic "factual" questions about international pay. Based on some recent research and discussions with scores of multinational firms, Chapter 12 attempts to begin to remedy the situation. As companies are becoming more global, this is becoming increasingly important and is an area where managers could do small things well and increase their firms' profitability with much less effort than many other possibilities. Chapter 13 explores compensation in the nonprofit sector and suggests the similarities (of which there are many) and differences in pay in it, relative to the for-profit sector.

By Chapter 14 you will likely understand quite a bit about how organizations set pay. Then you can apply that to your own organization and think about what you can do to make more. This includes simple and obvious things like "do your work," "work hard," "be respectful of those who evaluate you and set your pay" and less obvious ones like being sure you understand the mission of the organization and what *you* do to meet that objective so that you may be able to increase your earnings while you help the organization. I also discuss what you can do in the long run to make more money, including training, continuous learning, not being afraid to change jobs or try something new, and even having a willingness to change occupations or move.

In Chapter 15, I offer a summary and some concluding thoughts. Again, designing pay plans and considering what you can do now (and later) is not rocket science. But it isn't easy either. I hope this book helps you learn more about how and why people are paid what they are paid, as well as how to earn more yourself.

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Kevin F. Hallock
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More information

TWO

Wages, the Wage Distribution, and Wage Inequality

This chapter focuses on four main areas. First, how much are people paid in the United States today – how are wages distributed? If you earn $25 per hour, is that relatively highly paid or not? Second, we will consider the issue of wage inequality. Given the obvious news about CEO pay levels, clearly *some* people are paid extremely high wages, but how many? Do a large fraction of people earn less than $10 per hour? Do a large fraction earn more than $50 per hour? After we establish the "spread" in wages across different kinds of workers, we will turn to the question of whether wage patterns and wage inequality have changed over time. Using data from the U.S. Census Bureau over a thirty-year period, I document that the "spread" in wages in the United States has, in fact, changed quite dramatically in the last generation. Next, I document the difference between CEO pay and that of "other" workers. As has been documented, the difference between CEO pay and most other workers' pay has increased greatly in the last generation. In this chapter, we explore what this means and foreshadow a deeper discussion of executive compensation, which we pick up again in Chapter 8. Finally, I discuss the intergenerational correlation and transmission of wages. That is, if you have a wage that is particularly high or low, how likely are your children to have the same kind of wage?

What do Wages Look Like in the United States?

The "median" wage in the United States was $16.83 per hour in 2010.[1] This means that just as many people earned more than $16.83 per hour that year as earned less than that. It was the "middle" wage. Is this number big or small? Your answer to that question may depend on whether you or your friends or family or people you know make more or less than that amount (more on this later). A few years ago, I took a group of (roughly