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Jed DeVaro
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1 Introduction

You have almost certainly received pay for work you have done. Similarly, you have likely paid someone else for work they have done for you. For example, every other week I pay $40 to a gardener who comes to my house, every few weeks I pay $20 for a haircut at someone else's house, and every so often I hire a student to work as my research assistant at $12 per hour, with all of these payments serving as compensation for the services rendered. Such payments are what jump to most people's minds when they hear the words "pay" or "compensation" . . . they think of cash, or alternatively, hard-copy paychecks or electronic deposits that can be easily converted to cash. But compensation is a broader concept encompassing more than cash payments.

1.1 What Is Compensation?

A person's total compensation is properly understood as including *everything that the person likes about a job*. Examples include wages and salary, bonuses, health insurance, a 401(k) plan, on-site childcare, paid vacation, promotion opportunities, a collegial work environment, an understanding boss, job stability and security, flexible hours, a corner office with a big window and a nice view, low commuting costs from the employee's home, a relaxed dress code, good weather, and an appealing geographic location. That's already a lot, and it's only a partial list. Some of those items are direct costs that appear on your organization's balance sheet (e.g., salaries, bonuses, and 401(k) plans), whereas others are not (e.g., good weather and a relaxed dress code). From your employees' perspectives, compensation should usually be thought of using the broad definition just given, but sometimes it's appropriate to speak of it more narrowly in terms of the monetary and non-monetary payments you directly provide your employees.

From your perspective as a manager, when discussing compensation costs the relevant concept is usually the actual dollars you must spend as a consequence of employing an employee. Some of those compensation costs may provide your employees with no value, or even negative value. For example, in the United States, Social Security taxes are partially paid by employers. Those taxes are direct

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compensation costs to you as the employer, but they aren't directly valued by your employees because the government gets the money. On-site childcare is an example of a compensation component that imposes direct monetary costs on you but might have zero or even negative value for some of your employees. Whereas your employees with children may value the component positively, those who are childless may view it as a negative if the noise from screaming children on the premises creates a distracting work environment. Your childless employees might also worry that your childcare expenditures may leave you with less money to spend on salaries.

When it comes to components of compensation that do not involve direct monetary costs to you as the employer (e.g., good weather, a collegial work environment, or a relaxed dress code) the potential for your employees to disagree over the value of those items is even greater. While everyone agrees that monetary bonuses are desirable, opinions may differ wildly concerning what constitutes a collegial work environment. What one employee finds fun and highly social, another might find annoying and distracting. Some of the compensation components that involve direct monetary costs are at least partially within your control as a manager (e.g., wages, salaries, and bonuses), whereas others are not (e.g., mandatory overtime pay, and Social Security taxes). The same is true for the components that do not involve direct monetary costs. For example, as a manager you can control the dress code, but you can't control the weather and the appeal of the geographic location. Both for the components you can control and for those you can't, you should remember that your employees may have different valuations for them. What is vice to one worker is virtue to another.

The fact that employees and firms have different perspectives on compensation, as explained above, does not mean that the two parties ignore each other's perspectives. Suppose that the government imposes a new payroll tax on employers, calculated as a percentage of the salaries that you pay your workers. Your first impulse might be to say that your employees are unaffected, because this is a tax directly on, and paid by, you as the employer. But that's wrong. By lowering your employees' compensation, you can pass along to your employees at least part of any increase in costs, and you might even fire some of them or cut back their hours if they become too expensive. So your employees should care about increases in your labor costs.

Similarly, consider a change in your employee's valuation of a job characteristic that is beyond your control and not paid for by you (e.g., desirability of the geographic location). Your first impulse might be to say that factors beyond your control as an employer, and that aren't paid for by you, should be of no concern to you. But that's wrong. Suppose, for example, that your employee's affinity for the geographic location of your organization is driven by the fact that her husband's

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family lives there. If your employee gets divorced, which causes her affinity for the geographic location to diminish, then it becomes easier for competing firms in different locations to poach her. So from the standpoint of retention and talent management, you need to think about compensation from your employees' perspectives as well as from your own.

1.2 What Is "Strategic" Compensation?

Although "compensation" is the most important word in the book's title, some of the other words also deserve comment. "Strategic" is a buzzword that is used often in the management domain, but it is not always used consistently, and the intended meaning is not always clear. There's also some inherent redundancy in the term "strategic ______". For example, consider the term "strategic human resources management". As opposed to "non-strategic" human resources management?? Any employer who manages the company's human resources "non-strategically" should be fired immediately, and the same goes for any employer who designs and administers the company's compensation system "non-strategically"! The adjective "strategic" can usually be omitted in management contexts, because it is implied and should be understood.

My decision to start the title with "strategic" was strategic, i.e., it was "purposeful", or "with an eye toward achieving some objective(s)". Even at the risk of some inherent redundancy, there is value in reminding the reader that compensation systems must be designed and managed in a manner that furthers the organization's *objective*, of which I will say more shortly.

1.3 What Is Talent Management?

Talent management is defined in various ways by different authors. For concreteness, let's consider the definition offered by Wikipedia (accessed August 20, 2019):

> *Talent management is the science of using strategic human resource planning to improve business value and to make it possible for companies and organizations to reach their goals. Everything done to recruit, retain, develop, reward and make people perform forms a part of talent management as well as strategic workforce planning.*

That definition is as reasonable as others I've seen (despite two instances of the inherently redundant "strategic"!), so let's just roll with it. If the crucial role that compensation plays in talent management isn't already clear to you, hopefully it will be by the end of this book.

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1.4 What Is Your Organization's Objective?

The preceding definition of "talent management" uses the important phrase "to make it possible for companies and organizations to reach their goals." A proper discussion of compensation must begin with a clear statement of the organization's goals or objectives. For most of this book, we will assume that the organization seeks to improve its bottom line, i.e., to maximize profit. That's a bit of an oversimplification, and it requires some qualifications, but in most organizations, at least in the private sector, it's a reasonable approximation to what's really happening and should be happening.

In the phrase "maximize profit" the word "maximize" is more important than the word "profit". The approach we will take in this book is to clearly identify an objective that the organization is trying to maximize or "manage towards", and all decisions that are made can be evaluated by the extent to which they further that objective. Organizational objectives other than profit are found in nonprofit and public-sector organizations (Chapter 15). The concept of "profit" exists in both the short-term and the long-term. Generally, when we say that the organization maximizes profit we mean long-term profit. A business decision that would lead to a loss in the short-term (perhaps because of a large fixed cost that must be paid upfront) would be wise if it could be expected to yield a future profit stream that exceeds the initial fixed investment cost. When evaluating future expected profit, it is important to "discount" properly, as I explain in Chapter 8.

My claim that organizations maximize profit might seem strange for the following reason. If they're truly successful in maximizing profit, then there's no role for you as a manager to improve matters. If the maximum profit is already achieved, profit obviously can't go any higher. You should think about this in the following way. Profit maximization is something that good managers and successful firms aspire to do, but not always with perfect success. So even if they are close to achieving maximum profit, but not achieving it perfectly, there is still room for you as a manager to improve the situation through good business decisions. And even small increases in profit can be of major consequence, particularly in highly competitive industries in which organizations are constantly struggling to survive.

Finally, regarding this section's title, note that throughout the text I use the words "organization", "firm", and "company" more or less interchangeably, whereas I use the words "establishment" or "workplace" or "production unit" to describe an individual production unit at a particular physical location. For example, McDonald's is a firm (or organization) that has many establishments (or workplaces) worldwide, including a restaurant right down the street from my house. I also use the term "employer" to describe the entity that makes decisions about compensation, and in situations in which it matters, the context will make clear whether the

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term refers to a firm or to an establishment. In many workplaces, decisions about different components of the compensation system are made at different levels of the organization. For example, in a multi-establishment firm operating in many locations, the senior management at each establishment might have the discretion to set salaries at their locations, whereas the benefits packages are set at the company's headquarters and apply company-wide.

Another note on terminology is that I use "employee" and "worker" interchangeably even though a distinction between these terms is sometimes implied by the Fair Labor Standards Act of 1938 (Chapter 4). In other books the term "worker" sometimes implies hourly (or "non-exempt") employees who must be paid time-and-a-half for overtime, whereas the term "employee" implies both "exempt" (i.e., salaried people who are not eligible for overtime) and non-exempt statuses.

1.5 Who Cares about Compensation?

Workers obviously care a lot about compensation. For most of us, the bulk of our income is from paid work. Employers also care a lot about compensation, for several reasons. Compensation is a substantial chunk of total costs for most firms. Compensation also affects the behavior of a firm's current workers, so changing the compensation system may cause those workers to change their behavior in ways that may help or hinder the firm's objectives. Moreover, compensation affects the type of worker the firm can attract, so changing the compensation system may encourage some types of workers to leave the firm while making other types more eager to join the firm. For all of these reasons, you cannot be a competent manager without understanding the design, operation, and implications of compensation systems.

1.6 Who Receives Compensation, and Who Doesn't?

Most people get compensation, or did in their past, but several types of people get no compensation. Some people have marketable skills for which they could be compensated in paid employment, but they choose not to work (or, equivalently, they cannot find work at the compensation level they demand). Examples would be retirees and most of the unemployed. Other people have no marketable skills for which they could be compensated in paid employment. Examples include young children or unemployed people who are physically or mentally incapacitated and who lost skills, or never acquired them.

The preceding types of people don't get paid because they don't work, either voluntarily or involuntarily. Another type of person actually works (potentially

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very hard) but still doesn't get paid, namely slaves. Of course, we don't see much slavery in modern economies. But a close counterpart to slavery in the modern economy can be found in prisons. Prisoners, at least in the United States, typically have the option to not work, so compensation (albeit very meager compensation) must be offered to entice them to work. Prisoners have no "outside options" for employment; all of their employment options are inside the prison. Their only "outside" option is, perhaps, to not work at all. The consequence of this lack of outside options is exceedingly low wages, commonly pennies per work hour, which is legal because prisoners' labor is exempt from federal and state minimum-wage laws. Because slaves effectively lack even the most basic outside option of not working at all, their wages are zero. The examples involving slaves and prisoners offer a useful conceptual benchmark for thinking about compensation, because these individuals lack, or are severely restricted in, *mobility*. That is, they cannot "leave and go work for someone else", nor can they become entrepreneurs and start their own businesses.

Compensation is a "three-legged stool" that requires *desire* (to work for pay), *skills*, and *mobility*. If any of the three legs are missing, the stool collapses and there is no compensation. In the case of retirees, desire is missing, at least in the United States where mandatory retirement laws have been abolished since 1986. For retirees who have desire but are involuntarily retired because of mandatory retirement laws, mobility is effectively missing, because the law severely constrains it by preventing the worker from being employed in a company. However, even in this case mobility probably isn't completely absent, because the person still has informal work options, such as giving piano lessons out of his or her house. In the case of children or the incapacitated, skills are missing. And in the case of slaves, mobility is missing. So remember:

$$Compensation = Desire \times Skills \times Mobility$$

The legs of the stool are *multiplied*, not added, which means that if any one leg is zero, compensation is also zero. Like slaves and prisoners, wage-theft victims (see Chapter 2) actually work, potentially very hard, despite not getting paid. But wage-theft victims differ in some ways from slaves and prisoners. Whereas slaves and prisoners *expect* not to be paid, or expect to be paid very little, victims of wage theft are typically caught by the surprise of a broken promise. Thus, while the employment relationships involving slaves and prisoners can be very long lasting even in the wake of sustained absence of compensation, that doesn't normally happen with wage-theft victims. Workers suffering wage theft typically have mobility, and even a single instance of wage theft might be enough to prompt them to quit and work elsewhere. This is a central idea underlying section 10.5, which discusses the threat that CEOs and other executives might quit if the bonuses that they were promised are withheld, in whole or in part.

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Note that for a particular worker with given levels of skills and mobility, the third leg of the stool (desire) determines the *minimum* compensation level that they'd be willing to accept. That minimum level is often called the worker's ***reservation wage*** or ***reservation compensation***. Workers who have low desire to work have high reservation wages. You'd need to pay them a big reward to entice them to take the job!

1.7 How Does Compensation Relate to Incentives and Productivity?

Compensation is the most powerful tool at a firm's disposal for creating and shaping worker incentives. When workers behave in ways that hurt the firm, most of the time the problem can be traced to poor incentives resulting from a badly designed compensation system. Compensation is both the disease and the cure. It's often the cause of the bad worker behavior. But usually the bad behavior, regardless of its cause, can be improved by fixing the compensation system.

Worker productivity also connects closely to compensation, because firms hire workers, and pay them, to be productive. Productivity is both a cause and a consequence of compensation. Productivity causes compensation because the main components of compensation are usually payments given in exchange for past productivity. But compensation causes productivity because often the design of the pay system affects workers' productivity (see Chapters 9 and 10). For example, sales workers who are paid on commission may feel compelled to sell more items than those paid hourly wages.

1.8 Four Recurring Themes

As noted in section 1.5, compensation affects the behavior of your current and prospective workers in two ways. First, the behavior of your current workers is affected by the design of the compensation system, and typically the behavior of greatest interest is *effort*, i.e., how hard people work. I refer to this as the *incentive effect*. Second, the types of workers who are attracted to your firm are affected by the design of the compensation system. I refer to this as the *sorting effect*.

The book's first recurring theme is that incentive effects and sorting effects arise when your company changes its compensation system. The key distinction we really want to draw between the two effects concerns changes in the behavior of your existing workers versus changes (via turnover) in who actually works for your firm. When we're focusing on your existing workers, typically the behavior of greatest interest is their level of effort on their job tasks, though other behaviors are

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sometimes also of interest. The following mnemonic might help you to remember and distinguish between the two effects.

The sorting effect concerns who shows up for your party, whereas the incentive effect concerns how they behave once they arrive.

A second recurring theme is that pressure from market competition largely dictates the *level* (i.e., overall generosity) of the compensation packages that you must pay your workers, whereas you have more control over the *design* of the compensation system, given its level of generosity.

A third recurring theme is that, as an employer, whether you like it or not, you are effectively forced to care about what your workers want. The reason derives from the "three-legged stool" mentioned earlier, and in particular the "mobility" leg. When hiring and retaining workers, you must compete with other employers in the labor market. And your workers are mobile, meaning that they are free to quit and go work for someone else or simply to do their own thing. So if you don't pay attention to what your workers want, and your competitors do, you're likely to lose them to your competitors. You are, therefore, forced by worker mobility and market competition to care about what your workers want, even if that is not your preference.

A fourth recurring theme is that *bargaining power* also determines the level of compensation, and the strength of your workers' outside markets affects their bargaining power vis-à-vis you, the employer. Chapter 14 elaborates.

1.9 What Constitutes "Fair" Compensation?

There is a lot of discussion in the popular press, in the political realm, and from some corners of academia, concerning the philosophical question of what constitutes "fair" compensation. Such discussions tend to become emotional and incite the expression of strong opinions. A related question concerns the fairness not of my compensation, as an individual, but of mine compared to my co-workers'. For example, as we'll discuss in detail in the next section, in the CSUEB business school where I work, as in most others, it is not uncommon for professors who do virtually identical work (i.e., teach the same number of classes, along with the standard expectations for research/publishing and committee work) to have vastly different compensation levels. Is that fair? Similarly, is it fair that CEOs earn many multiples of the pay received by even the hardest-working employees at the bottom of the organizational hierarchy?

Such questions of fairness will receive little attention in this book, which is not to diminish the value of studying them. They would take us too far into the realm of social and political philosophy. This is a book written for managers, and that should be our focus. The central compensation issues for you as a manager don't usually

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concern your workers' perceptions of fairness, except to the extent that those perceptions have implications for worker productivity and turnover. You should be focused on improving your firm's bottom line, which usually means paying as little as possible for a given amount of worker productivity. I do not mean to suggest that you should consider your workers' perceptions of fairness irrelevant! To see why, refer to the third recurring theme of section 1.8. Understanding what drives your workers' perceptions of fairness in compensation may enable you to design your company's compensation system in a way that "looks fairer", potentially reducing compensation costs and improving the bottom line.

But while we're on the subject of fairness in pay, I can't resist saying a few words about CEOs. Because, after all, CEOs get paid a lot. I mean, *really*, a lot! Elon Musk, CEO of Tesla, received over $513 million in total compensation in 2018. On the other hand, poor Stephen Angel, CEO of Linde PLC, earned a mere fraction of that in 2018, at just over $66 million, though even that paltry sum still put him among the 10 highest-paid CEOs in 2018. So there is enormous variance across companies in what CEOs get paid, though, no matter how you slice it, they still get paid way more than the rest of us, and usually way more than all of their employees. *Are they paid too much?* If you're ever asked that question, your immediate response should be, "Relative to *what*?" We can't address the question of whether CEOs are paid "too much" unless we agree on the correct benchmark for comparison. Opinions on the proper benchmark may vary, but I'll give you the quick version of my own opinion, just so that we can lay the issue to rest and move on to more pressing matters . . .

A CEO is paid "too much" if the company could readily find a new CEO who's just as good as the current CEO and who will create just as much value for the company, but who is willing to do the job for less compensation. A question I'll leave you to ponder is, if such a person is indeed readily available, why hasn't the company already made the switch?

1.10 Secrecy versus Full Disclosure of Compensation

At the reference desk on the second floor of the CSUEB library, if you provide your university identification card as collateral, you can request the "faculty salary data folder". It names each member of the CSUEB faculty and what their cash compensation was in the previous year. The same information can be found online. After a few years of noble resistance following my arrival at CSUEB in 2008, I finally broke down and satisfied my curiosity by spending part of an afternoon with that folder, in a lounge in the library. In an email instructing me on the location of the folder and how to access it, a colleague of mine in the business school's Management Department (who, incidentally, felt underpaid) wrote, "Be prepared to be amazed."

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I was, indeed, amazed! What was so amazing? Mainly the gross mismatch between the salary figures and my own perceptions of the productivities of the individual faculty members. For example, the highest-paid professor in the business school at that time wasn't doing any research, had never published in a major journal, and wasn't making any major contributions in either teaching or administrative work. In contrast, there were individuals who excelled on all of those dimensions despite being near the bottom of the salary scale.

A short time after I discovered the salary data, a senior professor independently sent an email to the entire business school faculty, including the salary information as an attachment. Her goal was to stir up trouble, and she sure succeeded. Some professors became upset and disgruntled, and one of the business school's best professors (who happened to be among the lowest-paid) actually left CSUEB for another university. The departure of the talented professor was the first time I had witnessed, firsthand, the potential costs to organizations (in terms of low morale, and turnover) of having internal compensation information publicly available and known.

Prior to joining CSUEB, I spent seven years on the faculty at Cornell, and there the compensation data were private. Only the dean knew what individual faculty were getting paid. Because the dean at the time knew of my interest in compensation, he revealed to me once in conversation how large the variance in salaries was within the school, without revealing any individual salaries. That is, if you consider the highest-paid and lowest-paid professors of a given rank, the highest-paid one receives K times the salary of the lowest-paid one. Although I will not disclose that K factor here, the number he reported was surprisingly large.

Recalling this story several years later while sitting on the second floor of CSUEB's library with the faculty salary folder, I decided to compute K for the CSUEB business school. The number was definitely not small, but it was way smaller than the corresponding number from Cornell. This is no surprise. Organizations like CSUEB that have public compensation information tend to have more "compressed" compensation distributions (i.e., there is less distance between the highest-paid and lowest-paid worker) than those like Cornell where almost everyone's pay is a secret. There are other differences between the two institutions that likely play a larger role in explaining the difference in K values (e.g., CSUEB is unionized, and in Chapter 5 we'll discuss the important role that unions play in compensation compression), but the difference in information disclosure likely contributes.

The fact that compensation disclosure goes hand-in-hand with compensation compression raises the question, does the disclosure cause the compression, or does the compression cause the disclosure? The answer is, both! When you disclose salary information to your employees, two considerations lead to compensation compression. First, your lowest-paid workers will learn that they are the lowest-paid, and they will either aggressively lobby for raises or they will quit, and either of those

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