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Tools and Techniques for Designing Effective Compensation Systems

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INTRODUCTION

Employees are the most essential resource of an organization. They are vital to a company's success. Without them, it would seize to exist. Management will probably give employee compensation the first place in their priority list and rightly so. Because the importance that compensation holds for their lifestyle and self-esteem, individuals are very concerned that they be paid a fair and competitive wage. Organizations are concerned with pay not only because of its importance as a cost of doing business, but also because it motivates important decisions of employees about taking a job, leaving a job, and performance on the job. Hence, one of the most vital factors for attraction, motivation, and retention amongst the employees is the compensation system, policies, and review philosophies of any organization.

Compensation as a function of human resource management that involves rewarding employees for performing organizational task is one of the most complex functions of the human resource manager.

A lot of studies have shown the various components of compensation both for the executives and the employees, but no study has focused on the tools and techniques for designing and implementing effective compensation systems. Therefore, this article will look into these tools and techniques of effective compensation systems. To be able to do this effectively, we will look at the various definitions of compensation in the background to the study, the features of good compensation tools, the rationale for choosing effective compensation tools, and the various compensation tools we have—both intrinsic and extrinsic.

BACKGROUND

The human resource management (HRM) profession and practices have undergone sustainable change and redefinition. Many articles written in academic and practitioner literature have been critical of the traditional HRM function. Unfortunately, in many organizations, HRM services are not providing value but instead are mired down in managing trivial administrative tasks. Where true, HRM departments can be replaced with new technology or outsourced vendors who can provide higher-quality services at a lower cost. This recommendation though somewhat extreme, it follows then that companies need to ensure that their HRM functions of which one of them is compensation management are creating value for the firm. Belcher (1979) states that compensation "is a double input-output exchange between a worker and an employer," implying the inputs of effort and output of wages to the workers on the one hand and the inputs, productivity, and service on the employer's side. This connotes that employee's trade labor and loyalty for financial and non-financial compensation. Compensation includes topics in regards to wage and/or salary programs and structure, merit-based programs, and bonus-based programs including benefits. It can be viewed as a matter closest to the heart of every employee and employer (Banjoko, 2002).

Sesan (2000) admitted that employers/management and employees are in a dependent relationship such that employees have their skills, knowledge, manpower, experience, and information to offer in exchange for rewards from employers that may be financial or non-financial.

Ivancevich (2003) submitted that financial compensation includes pay received in the form of wages, salaries, and bonuses or commissions as well as vacations, insurance, paid sick leave, scholarship payment, and so forth, while non-financial compensation affects an employees motivation, productivity, and satisfaction—this includes: recognition, promotion, praise, and so forth.

Fogleman, McCorkle, and Schwert (1999) considered compensation packages as the total rewards systems that contain non-monetary, direct and indirect elements.

Non-monetary compensation is any benefit an employee receives from an employer or job that does not involve tangible value. These include career and social rewards, such as job security, flexible hours, opportunity for growth, praise and recognition, task engagement, and friendships.

Direct compensation is an employee's base wage, which can be an annual salary, or hourly employee receives such as profit- sharing bonuses. And, indirect compensation includes everything from legally required public protection programs such as social security to health insurance, retirement programs such as social security to health insurance, retirement programs, paid leave, child care, or moving expenses.

The general consensus of recent studies is that pay should be tied to performance to be effective; for instance, a company may offer a bonus for meeting a performance objective. Therefore, successful managers must search for areas that employees do influence and base performance objectives on these areas, for example, offering of tenure bonuses for long-time employees, equipment repair incentives to encourage good equipment maintenance, or bonuses for arriving at work on time. Not only that, Rosenberg (1999) itemized the following as direct compensation alternatives and indirect compensation alternatives:

A. **Direct compensation alternatives** include:
   - **Base pay:** Cash wage paid to the employee.
   - **Incentive pay:** A bonus paid when specified performance objectives are met.
   - **Stock options:** A right to buy a piece of the business, which may be given to an employee to reward excellent service. It is believed that an employee who owns a share in a business is more likely to go extra mile for the organization.
   - **Bonus:** A gift given occasionally to reward exceptional performance or for special occasions.

B. **Indirect compensation alternatives:** These include flexible working schedules, laundry services, wellness programs, child care, elder care retirement programs, insurance, paid sick leave or holiday leave, clothing allowance, subsidized housing and utilities, moving expenses, and so forth.

Moreover, some workers view compensation as a return in an exchange relationship between them and their employers. Others view it as what they are entitled to as a member of an organization. It should be competitive and easy to administer (Klingner & Nalbandian, 2003). Compensation in other terms is also called "employee remuneration" (Mazumber & Mazaheri, 2002).

To the employee, Banjoko (2006) states that "compensation includes wages, salaries, and payment of all other extrinsic financial rewards which affects the totality of the employees temperament, attitudes, work behavior, and the overall performance of the organization in terms of its outputs, quality of its outputs, and its competitiveness in the industry." The significance of employee compensation can be examined from the angle of its:

- **Economic role:** Money or expectation of money is the most crucial incentive to work. If not for money that comes out of work, many people will not work. Bjorkman and Fan (2002), in their study, made it clear that for a large majority of work force, a regular pay check is absolutely necessary to meet their basic physiological and safety needs.
- **Political Role:** Good remuneration/compensation which puts one in good financial standing can confer on one the use of power and political influence which in turn can help in placing one on a much higher political and financial footing.
- **Social role:** Money classifies an employee into several social classes. An employee's salary grade is a status symbol and determines his social rating in the society.
- **Psychological role:** Money is for inducing desired behavior. Where an attractive pay or incentive is offered, an employee can be motivated to behave in a manner consistent with the attainment of high productivity and profitability. Opsahl and Dunnette (1996) declared that money is a generalized conditioned reinforcer, which can be used to condition an employee's work attitude and behavior in a manner that will be beneficial to the organization.

To the employer, employee compensation in terms of its components (i.e., basic pay, incentives, and benefits) is significant because of its contribution to the cost of production. It is the most single expensive item of cost to the employer: Hence the need for efficient management of the compensation system to ensure that compensation is paid out to services actually rendered.

Besides, battles in the form of strikes and lockouts are fought between the employees and the employers on issues relating to wages and wage differential acceptable to employees and their leaders. Not only that, employee's compensation is the major factor in attracting the best skills in the labor market to the organization; retaining as well as motivating them towards excellent performance.

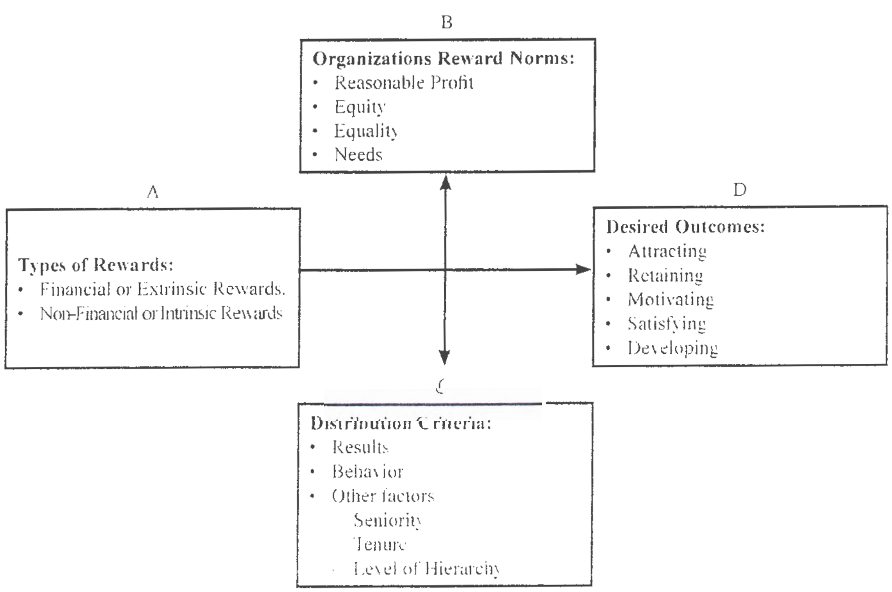
From a study of Sidgwick (1989), he identified features of good compensation tools as including the following:

- Compensation tools must focus on desired behavior and provide the employees with a clear line of sight and differentiation between action and desirable results.
- It must be meaningful and valuable to the individual employee to make the required efforts worthwhile.
- It must retain its market competitiveness so as to achieve the basic objective of attracting, retaining, and motivating.
- It must be timely and immediate.
- It must reward positive work behavior and sanction negative work behavior.
- It must maintain proper balance between extrinsic and intrinsic needs of the employees.
- It must satisfy individual needs.

Before considering the framework of compensation policy, it is necessary first to consider the rationale for effective compensation tool; these are:

1. It performs a labor market function by helping to allocate skilled individuals to firms in accordance with the perceived attractiveness of jobs expressed by the pay offers.
2. It helps induce employees towards higher performance.
3. It helps in applying the principles of rewards and sanctions to employees who identity with the organization action rules are those who defy the rules.
4. It enables the organization to get maximum results from its limited means through adequate control of its labor costs.
5. It helps keep employees aware that pay policies and pay levels are fair and will be applied across the board, uniformly without favoritism and discrimination.

Figure 1. A framework for the effective compensation tool (Source: Adapted from Kreitner & A. Kinicks, 1995; p. 425)



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The best performance appraisal system in the world will not work if it is linked to a reward and compensation system that employees do not trust or support (Banerd & Rodger, 2000). A motivated employee will achieve a great deal. A de-motivated employee will be slow, prone to error, and not likely to achieve. Figure 1 provides a framework for understanding the effective compensation tool.

Box A: Types of Rewards

From box A, two (2) types of rewards can be identified. These include the financial or extrinsic rewards covering the monetary or financial rewards. On the other hand, the non-financial or intrinsic rewards include the verbal or written commendation, recognition, appreciation of each of these that will help achieve the desired organizational outcomes, thereby take decision as appropriate.

Box B: Organizations Reward Norms

Organizations in designing the appropriate compensation structure take into consideration certain norms and principles that streamline the design and the implementation of the compensation systems in a way that will enhance corporate efficiency and safety individual's aspirations. These norms and principles are:

- **Reasonable profit norm:** Since profit maximization is the sole objective of business organizations, any business organization will attempt to pay the least amount of wages and salaries while expecting maximum efforts from the workers. Therefore, organization quest for profit maximization will play a significant role in its reward allocation.
- **Equity norm:** This norm indicates that organizational compensation structure design and implementation must ensure that rewards are given to employees in proportion to their level of contribution—meaning hardworking employees and lazy ones should be compensated accordingly.
- **Equality norms:** This norm calls for rewarding of employees equally, regardless of their contributions. This is applicable in cases where employees work in groups and the output of one employee cannot be easily determined.
- **Needs reward norms:** This norm calls for distributing rewards according to employees' needs rather than their contributions. The norm required that the organizational rewards be fashioned in a way that will reflect the peculiar needs of the various categories of employees.

Box C: Rewards Distribution Criteria

Three important considerations usually are in focus in distributing organizational rewards. They include:

- **Result consideration:** The emphasis here is on results, performance, or achievement and not on mere efforts. Reward is linked to performance, thus performance is quality or quantity of work done is the criteria for compensations.
- **Behavior consideration:** This emphasizes behaviors that are helpful in achieving organizational objectives. These behaviors include co-operation, team spirit, creativity, risk-taking, dedication, loyalty, and so forth.
- **Other considerations:** This focuses on non-performance considerations such as seniority, tenure, and level of hierarchy within the organization.

Box D: Desired Outcomes

A good compensation system should accomplish some desirable outcomes, which will be able to enhance the attainment of corporate goals and objectives:

- The compensation system must be able to stimulate attitudes conducive to high job performance, loyalty, and commitment to the organization.
- It must provide job satisfaction to the employees
- It must stimulate employees' growth and development
- It must be able to attract the best skills
- It must be able to retain valued, productive, and competent people
- It must continue to enhance the motivational spirit of the employees

COMPENSATION TOOLS

How can an employee be efficiently and effectively compensated? Compensation programmes are one of the most powerful tools available to organizations.

Various researches recently have been on extensive compensation systems and few researches have been in the areas of which compensation tools need to be combined. both financial and non financial, to reward an employee in return for his labor or services to the organization (Banjoko, 2004, 2006; Mathis and Jackson, 1982).

Presently, there are three basic classifications of compensation tools employers can combine to encourage their employees to perform at a higher level of efficiency. These are: the basic pay, performance incentives, and the benefits. They make up the employee's reward for making himself available for the services of the organization.

Basic pay is the fixed or guaranteed monthly or annual gross payment made to employees—in other words it is the hourly, weekly, or monthly pay to employee.

Performance incentives are rewards offered in addition to base wage/salary, and are usually directly related to performance. Fashoyin (1980) classified performance incentive as individual-based performance incentive schemes, group-based performance incentive schemes, and organization-wide performance incentive schemes. Mathis and Jackson (1982) noted that an individual incentive scheme is used as a means of measuring individual capabilities and initiatives. He further divided the individual incentives schemes into:

- The straight piece work-plan;
- Differential piece rate plan;
- Guaranteed piece work plan: and
- Bonus incentive plan.

However, group-based performance incentives according to Mazumber and Mazaheri (2002) are given where the jobs are interdependent and an individual performance level cannot be assessed. Finally, the use of organization-wide performance incentive rewards individual or group efforts (Banjoko, 2006; Klingner & Nalbandion, 2003: Opsahl & Dunnette, 1996). They are given to all employees on the basis of how well the organization has performed over the year. They include the 13th month pay. the bonus scheme. employee stock options. profit sharing incentive scheme. and gain-sharing scheme.

Recent research studies identified that benefits otherwise known as in-kind rewards are also part of the tools of compensating employees based on their membership in the organization. As Howard (1999) pointed out, a benefits plan suggests the importance of considering individual preferences. the increasing diversity of the work force, and lifestyle realities when studying an employee benefit program.

CLASSIFICATION OF BENEFITS

In a research conducted by Thomas et al. (2004) in the Internet Based Benefits and Compensation Administration under Economic Research Institutes (ERI), the following classification of benefits was made:

- **Premium payments**: this is the period a worker has worked and it is on a daily or weekly basis.
- **Payment for special duties**: such as working on grievance redress procedures and labor contract negotiations.
- **Payment for health and security benefits**: include retirement plans, social security payments, profit sharing plans. group life insurance, and so forth.
- **Payment for time not worked**: this includes payment for sick leave and payment for time during which employee is under medical care, vacations, call back time, dressing time, and so forth.
- **Payment for employee service**: this includes cafeteria subsidies. house financing. and so forth.
- **Other expenditures**: this includes bonus, educational re-imbursements, uniforms/work clothes, meal allowance, severance pay, company product pack, car allowance, house ownership scheme, utility allowances, medical allowances, out of station allowances, transport allowances, long service award, festival or year-end bonus, and so forth.

Certain payments are legally required. they include: old age pension. survivor benefits. disability pension and payments made under the Workmen's Compensation Act, pension and group insurance. and payment for time not worked. It is agreed that there is need to successfully manage the compensation programmes of the human resources in the organization for the organization to maximize its competitiveness. Using new technology such as computer-aided manufacturing. virtual reality. expert systems. and the Internet can give companies an edge which will result in employees working smarter as well as providing higher quality products and more efficient services to customer. This invariably will lead to better remuneration (i.e., compensation) for the employees. Companies that have realized the greatest gains from new technology have human resource management practices that support the use of technology to create what is known as high performance work systems.

FUTURE TRENDS

The issue of compensation has become deeply rooted as a means of achieving organizational goals. Given the dynamic and fluid environment in which business is currently being carried on, it becomes imperative that organizations create value continually for shareholders, customers, and employees; at the heart of this is employee compensation. In order to motivate the employee to perform, compensation does not only have to be defined in terms of financial, it has to include other variables. Work, training, programs, and reward systems need to be reconfigured to support employees' use of new technology. Some important aspects of high performance work systems, which lead to employees being satisfied on their work are:

- Human resources and their capabilities;
- New technology and its opportunities; and
- Efficient work structures and policies (including compensation policies) which allow employees and technology to interact.

Many public and private sector organizations can also use e-HRM (electronic HRM) applications to give employees more ownership of the employment relationship through the ability to enroll in and participate in training programmes, change benefits, communicate with coworkers and customers online, and work "virtually" with peers in geographically different locations.

Human resource information systems have to rise to new challenges affecting the world of work. Teleworking (GCN, 2007) is creating opportunities for employees to work from their laptops rather than from fixed office/job location. The flexibility of adjusting working periods to suit staff family life styles is providing a new face of compensation. Payment of performance model is helping HR managers to redefine the management of compensation tied to output.

The goal of motivating staff performance is being attained by the free expression of staff choice to tie work volume and pace to agreed work pay.

Beyond exploring the multi-processes in compensation, there is need to also trace the interactions between compensation and career development. The trend of staff indicating interest in substituting leisure goals for paid employment should be interesting to study (Strohmeier, 2007).

CONCLUSION

For a very long time, compensation has been defined in terms of financial packages and rewards. Times are changing and the business environment is becoming fluid and dynamic. As a result, financial gains and rewards are no longer sufficient to retain high fliers in the labor market. Indirect compensation packages are now becoming pronounced and rewarding and organizations are taking advantage of them to remain on top of their chosen line of business. All these will help to attract, retain, and maintain a highly motivated and committed workforce.

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KEY TERMS

Basic Pay: Direct and financial reward paid to employees for doing their job.

Benefit: Indirect compensation aimed at maintaining employees in an organization.

Compensation: Financial and non-financial reward offered to an employee in exchange for work.

E-HRM: The planning, implementation, and application of information technology for both networking and supporting of actors in their shared performing of HR activities.

Financial Reward: A type of extrinsic reward, which comes from the work itself but is given by the organization to an employee to ensure that the work is done and rules are followed.

Incentives: Financial reward given to employees to encourage performance.

Job Satisfaction: The affective reaction of people to aspects of their work environment.

Non-Financial Reward: Intrinsic reward given to the employee that is not monetary.