



**Center for
Effective
Organizations**

**The Changing Landscape of Employee
Rewards: Observations and Prescriptions**

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Executive Summary

This article examines the dramatic changes in employee rewards since the Center for Effective Organizations (CEO) was created 35 years ago. The article first examines ten major changes in employee rewards, including a reorientation toward the external labor market; attempts to become more strategic; new rewards models; changes in base pay, benefits, and incentive practices; and changes in governance. Next, it considers macro factors explaining these changes, including labor supply and demand, workforce composition, competitive pressures, globalization, the decline of manufacturing, diminishing unions, technology, and regulatory and legislative changes. The article concludes with prescriptions for the future, including greater business leader direction for rewards, an investment perspective on rewards, the radical shift in rewards mix from benefits incentives for performance and development.

Employee rewards have changed dramatically since the Center for Effective Organizations (CEO) was created 35 years ago. This article examines these changes and considers why they have been so pervasive. It concludes with the author's prescriptions for future directions, which involve extending some changes and abandoning others.

The focus is on rewards for employees in the U.S. CEO's research mostly has examined rewards for employees in general, and therefore this article mostly avoids discussions of rewards for subsets of employees, such as executives, that are complex topics in their own right. The focus is on the U.S. because practices vary across countries, making generalizations difficult. However, countries that are part of a global economy have experienced many of the same pressures that have shaped rewards changes in the U.S., and practices probably are more similar across the globe today than they were 35 years ago. Many conclusions of this paper therefore apply to other countries as well.

During the past 15 years, the rewards profession has rebranded "Compensation" or "Compensation and Benefits" to "Rewards" or "Total Rewards." This article uses the newer terminology. The updated terms emphasize all types of extrinsic rewards (salaries, incentives, recognition, benefits) and sometimes, intrinsic rewards (job design, careers). To keep the discussion bounded, this paper focuses on extrinsic rewards, although a more complete view requires attention to both types of rewards.

How Have Employee Rewards Changed in the Past 35 Years?

Since the founding of CEO, changes in rewards for U.S. employees have been remarkable. Ten changes stand out.

1. Rewards design becomes market facing. Perhaps the most profound change in employee rewards in recent decades is that the shift in orientation from the internal to

the external labor market. Value in the internal market is based on the rewards of one position compared to others in the organization. An internal orientation sends the message to employees that, “What matters in setting your rewards is how you compare to others in the organization”. Value in the external market is based on what other companies pay in the relevant labor market for a position. An external orientation communicates that, “What matters is your external value; if you want more money, develop the skills and take the positions that the labor market values.” Rewards professionals have always balanced internal and external market positioning, but the shift in emphasis toward the external market has been dramatic, and the consequences have been far-reaching.

One indicator was a change in the method of determining wages and salaries. In 1979, rewards professionals devoted much effort to job analysis techniques such as point-factor plans that emphasized relative internal value. Simpler plans maintained internal equity by uncomplicated rubrics, usually seniority. Today, most organizations rely primarily on “whole job” market pricing that matches job descriptions to those in rewards surveys. A WorldatWork study of 941 organizations found in 2012 that, “Market pricing far exceeds all other job evaluation methods in prevalence. 88% of organizations use market pricing to some degree; 50% use market pricing exclusively. The point-factor approach, once the most common method a few decades ago, is far behind at 20%.”

One reason that the orientation shifted was because it could. External market data from large-sample compensation surveys became readily available by the 1980s. Salary survey data had been collected for decades, but the data were usually expensive, unsystematic, and of poor quality. Compensation managers often did their own surveys of a few peer companies. This changed beginning in 1982 when a Boston survey group was

found guilty of violating the Sherman Anti-Trust Act for using salary surveys to fix wages. Because third-party surveys collected anonymously and in large samples remained legal, anti-trust cases provided a huge boost to compensation firms selling surveys. The electronic compilation, collection, and distribution of survey data greatly decreased costs and increased survey quality. Surveys revolutionized salary administration. Today, the survey database for WorldatWork, the primary association of rewards professionals, lists almost 1,000 surveys, covering virtually every type of employee and organization.

Business needs also reoriented rewards toward the market. As competitive pressures escalated in the 1980s, companies began to rethink business models and cost structures. As the single largest expense for most companies and the greatest variable cost by far, rewards received intense scrutiny. Salary survey data enabled companies to better manage labor market position. Also impactful was the decision by large, diversified corporations to manage business units separately. Business units with different competitors and markets began to adopt different designs. Business units facing low cost, low margin competitors could lower reward costs to meet the competition, while high margin units competing fiercely for talent could increase or change pay as needed.

Finally, the tremendous rise of the rewards consulting industry and professional associations (primarily WorldatWork) helped to foster the external perspective. These organizations provided benchmark data, disseminated stories of what worked, and packaged “hot” offerings. This reduced the insularity of rewards professionals.

2. Strategic rewards design ebbs and flows. Rewards managers have always found safety in copying prevailing practices – the opposite of strategic design. Common practices and the innovations of prestigious companies are often labeled “best practices” in

the absence of evidence that such practices are best or that they best fit an organization's unique business needs. Market-oriented wage setting probably encourages copying by rewards professionals. However, a firm gains no competitive advantage from imitating its labor market and business competitors.

This pattern was broken during the period from the mid-1980s until the early 2000s. This was the "Golden Age" for reward system design, in which there was intensive experimentation with new rewards practices. The trigger was the demand by corporate leaders that reward systems better meet business needs, coupled with the belief that new approaches offered potential competitive advantage. Business leaders challenged the instinct to look like everyone else, asked hard questions about pay levels, and looked at how reward systems might be leveraged to increase organizational performance.

There were two signals that compensation had become more strategic. First, new goals began to supplement traditional reward system goals. Cost control is the traditional goal of rewards that is often foremost for business leaders. Other conventional goals are attracting, retaining, and motivating employees. Few would challenge the importance of rewards in attracting and retaining employees. Motivating performance is more controversial partly because two best-selling authors, Alfie Kohn and Daniel Pink, have argued that extrinsic rewards do not motivate performance. However, every major academic review of rewards research in the past 35 years has shown that monetary incentives motivate employee performance, often strongly.

Traditional goals were supplemented by new goals: supporting the business strategy, reinforcing organizational structure, and enhancing the desired culture. For example, a company with an entrepreneurial business strategy wants a highly leveraged

reward system that encourages risk-taking. A business strategy that encourages operational excellence can be supported by incentives for cost cutting, quality, and on-time delivery. The most important organizational structures can be signaled by the reward system. For example, one forest products firm is comprised of small business units, each several interdependent plants. Business units (BU) are more important to company success than plant performance, and at times, plants sacrifice their own performance for the benefit of the BU. The management incentive system encourages the right behaviors by paying out 50% on plant performance and 50% on BU performance. Finally, a reward system sends strong messages about the culture desired by leadership, as employees see what is rewarded and as reward practices lead to self-selection in employment. For example, companies that strongly tie pay to performance communicate the importance of high performance, and they attract employees who want performance-driven rewards.

The second sign of strategic change was the emergence of new congruence models of rewards effectiveness. The new models indicated that the most effective reward systems were those that supported the business strategy, structure, and desired culture of a unique organization, and were reinforced by other human resource processes. Figure 1 depicts one such model – the current version of the congruence model that CEO has used for 30 years. The starting point is not benchmarking others’ rewards practices; it is the business needs of the organization. That opens the door to developing innovative pay systems that are not commonplace and that offer potential competitive advantage.

Insert Figure 1 about here

This Golden Age of rewards design (the mid-1980s to about 2002) was an era in

which “alternative rewards” were prominent, including changes in both base pay and incentives that are discussed below. Not all innovations survived, but the rewards field was never more exciting than during this era. Rewards professionals have looked ever since for the “next big thing” that would reinvigorate the field.

As this era ended over a decade ago, companies returned to the traditional design model of imitation. A key reason for this was the unrelenting management emphasis on cost control during a difficult decade that included two recessions. The risks of innovating were clearer than the opportunity to increase performance through innovation. This was reflected in the Mercer 2014 Total Rewards survey, in which only a third of respondents said their total rewards and business strategies were fully aligned. The rewards field has retreated to a less strategic, more mechanical, and less important position. The U.S. Bureau of Labor Statistics (BLS) provides shocking evidence of the degree to which this has happened. Since 2008, the number of U.S. Compensation and Benefits Managers has declined every year, and by 2013, 55% of those positions had disappeared from the economy. The lower strategic profile of the profession made it more irrelevant and more vulnerable to downsizing, not safer.

3. Emergence of the Silicon Valley model. The Silicon Valley rewards model emerged in the early 1980s and has continued to evolve in the technology sector. This model is the most radical departure from conventional practice in widespread use, and it is widely admired but poorly understood. To naive observers, the model appears to offer more of everything: pay, cash incentives, stock options and other forms of equity, standard benefits, and work-life benefits. Companies such as Google are famous for free on-site gourmet cafeterias, free on-site gyms, free dry cleaning, and much more. Such companies

become the basis for the common argument that a company will be more successful if it only demonstrates largesse toward employees.

Many outsiders misunderstand the model. First, the Silicon Valley labor market is unique. Companies go to extraordinary lengths to compete for labor because of tight labor market conditions that do not exist in most of the American economy. Second, the region includes many of the most profitable U.S. companies, and extraordinary margins make possible lucrative rewards. (Note that startups that are not making a profit do not tend to offer more of everything, even in the Valley, but they offer the dream of wealth through stock options.) Third, executives' do not adopt the model out of generosity; rather, it is a tested way of getting more from employees. An employee who never has to leave the workplace to eat, shower, exercise, run errands, or sleep is an employee who can work extraordinarily hours—and is expected to do so. Netflix CEO, Reed Hastings, has said that his company will pay more than an employee can make elsewhere, and in exchange, the employee will do the jobs of two people or the employee will not remain.

4. The incredible shrinking base pay increase. One of the most remarkable changes in rewards is the long-term, steady reduction in average annual wage increases. Figure 2 displays WorldatWork survey data from 1979-2014. Average wage increases dropped from over 10% in 1981 to about 3% today. The linear trend is disconcerting to anyone who earns a paycheck. Worst yet, increases in median wages barely outpaced inflation during the past 35 years. As Figure 2 shows, all types of employees experienced similar salary increases, including executives.

Insert Figure 2 about here

5. Revolution in benefit costs. Wages do not tell the whole story. As Figure 3 indicates, base pay now represents only 70% of the total rewards pie. Benefits, including a slice termed “supplemental pay” that we will discuss below, now represent 30% of *total rewards*. Said another way, the value of benefits is 43% of the value of *salaries*.

Insert Figure 3 about here

Benefits were a small part of total employee compensation until World War II. Then, government wages controls blocked increases, but permitted benefits increases. Benefits increases have continued unabated for 70 years. When the author joined the labor force in the 1970s, benefits were still referred to as “fringe benefits,” a term that is now oxymoronic.

Table 1 displays benefits changes since 1986, when the BLS began the Employer Cost of Employee Compensation Survey, presenting data for every third year through 2013. Benefits have increased at a much faster rate than wages. Although wages increased 115% during these 28 years, benefits costs increased 148%. If the same mix of wages and benefits existed today as existed in 1986, employees would be paid 4.2% more. That would be a bigger raise than the average employee has received in any year since 2001.

Insert Table 1 about Here

All types of benefits have risen faster than wages during this period. However, health insurance, the largest single benefit cost for employers, is the biggest culprit. Insurance costs (which are 94% health insurance) have risen more than twice as much as wages for decades.

6. Pensions go the way of the Woolly Mammoth. During the past 35 years, companies have been moving retirement plans from defined benefits (primarily, pensions) to defined contributions (such as the 401k). The rate of change is dramatic, and pensions may be headed for extinction.

After American Express adopted the first private pension in 1875, pension adoptions expanded for 100 years. The high water mark was 1980, when pensions covered 46% of all private sector workers. The first defined contribution plans were created that year, and the shift toward defined contributions was rapid and steady. The percentage of employees covered by retirement plans has hardly changed but most are defined contribution plans. By 2013, only 8% of private sector establishments offered defined benefit plans, and these covered just 16% of the workforce.

The shift to defined contribution plans has been a mixed blessing for employees. Company retirement spending has actually increased slightly over time. Defined contribution plans are fully portable – that is, employees take the accounts with them as they change employers. That is important as the one-company career disappears. The shift to employee control works to the advantage of employees who invest wisely. However, few U.S. employees are savvy investors. They pull money from the stock market when equities are cheap and buy equities when they are expensive, and they often withdraw funds to cover short-term costs or borrow against their retirement savings. Employees invest their retirement funds so poorly that many consider defined contribution plans a public policy failure. The average employee enters retirement with far less than \$100,000 in retirement savings – only enough for a small annual supplement to Social Security.

The shift away from troublesome pensions has benefitted companies. More than a

dozen major changes in pension law between 1980 and 2013 required ongoing revision of plans. Pensions became an accounting nightmare when companies were forced to treat shortfalls in pension funding as a balance sheet liability. Companies with shrinking employment, an aging workforce, or declining revenues found it increasingly difficult to cover unfunded pension obligations. General Motors, jokingly referred to as a pension plan masquerading as an auto company, went bankrupt partly due to pension costs.

7. “Work-Life” benefits become the rage. WorldatWork defines work-life benefits as, “A specific set of organizational practices, policies, programs, plus a philosophy, which actively supports efforts to help employees achieve success at both work and home.” The range of programs and practices in this category is overwhelming, and includes flex-time, telecommuting, sabbaticals, wellness programs, on-site massages, community involvement, dependent care programs of all kinds, pet insurance, adoption reimbursement, and diversity initiatives. Today, literally almost every company has some of these benefits for at least some employees.

There are several reasons for their popularity. The annual Best Places to Work listings focus largely on the exotic work-life benefits of the winners, leading to much creativity by those competing to join the list. The number of vendors in the space is vast and many are excellent marketers. Work-life perks are also a celebrated part of the Silicon Valley employment model, and the easiest part to copy.

There is little research evidence that work-life benefits lead to favorable outcomes. Most available studies are correlational, not causal. For example, companies that use more work-life benefits are more profitable. However, more profitable companies tend to adopt more innovations of all kinds because they can afford to – not because any particular

innovation causes profitability. A study by Pat Zingheim and Jay Schuster of 20 financial institutions receiving government bailouts following the market collapse in 2008 found that business executives viewed HR's enthusiasm for work-life benefits as fostering a culture of entitlement and high cost that made it difficult to mobilize the workforce in a crisis. Most abandoned work-life programs as a result.

8. Emergence of pay for skills, knowledge, and competencies. Skill-based pay rewards skill acquisition. Conventional systems pay for the job the employee holds, and the employee receives the pay even if he or she never performs the job expertly. By contrast, skill-based pay pays for the skills in the employee's repertoire, not for the job the person is currently performing. Pay follows formal certifications that the person has acquired skills. Such plans can reward all types of skills, including skill depth, skill breadth, skills or competencies at the next level of management in the organization, or some combination.

Skill-based pay can have several goals. Plans rewarding skill depth typically address the need for new or enhanced specialized skills. Plans rewarding breadth typically seek greater flexibility from employees to do a variety of tasks. Plans that reward acquisition of management skills typically are aimed at reducing supervisors and management layers. Whatever the plan goal, the usual expectation is that the company will have fewer, more highly paid employees, reducing overall cost.

Skill-based pay usage has grown slowly over time. CEO's triennial surveys of Fortune 1000 firms from 1987 to 2002 indicated that adoption of skill-based pay increased and that usage was broad but not deep. In 2002, 56% of companies used it, but only 13% used it with half or more of their workforce. WorldatWork provided more recent data in its

2012 Compensation Programs and Practices survey, reporting that 70% of private sector firms (but few government or not-for-profits) used skill acquisition as a base pay increase criterion. This suggests that the use of skill-based pay grew in the past decade.

There is a modest amount of research on the effects of skill-based pay, much of it conducted at CEO. The author has co-directed two large sample surveys, several case studies of skill-based pay use, and several reviews of the literature. The research evidence suggests that employees generally prefer this type of pay system and that it typically has a wide variety of positive effects on employee attitudes, skill acquisition, and performance.

Most skill-based pay takes the form of base pay. However, it is difficult to maintain base pay plans because of the need to mirror the organization's ever-changing mix of changes in technologies, team configurations, and task requirements. The typical plan must be redesigned every few years. Skill bonuses have considerable promise as a less burdensome and more flexible approach. The primary users of this approach today are the U.S. armed forces, where skill bonuses are used extensively for the attraction and retention of specialized talent (such as doctors, pilots, and Special Forces).

9. Incentive pay surges. Incentives are designed to motivate increased performance and to make pay variable. Incentives can take many forms. They can reward individual performance (individual bonuses, spot awards), group or unit performance (gainsharing, project group or work team incentives), or corporate performance (profit sharing, stock options). A given employee is often eligible for multiple incentives. Payouts can be based on improvements above past performance or meeting goals.

Most survey data on incentives are unhelpful. For example, BLS data do not clearly report incentive amounts, and classify some incentives as compensation but others as

supplemental pay benefits. Most surveys also do not account for eligibility in multiple types of incentives. The CEO Fortune 1000 studies again are useful here. Lawler reported in the 2003 study that the percentage of companies using performance-based rewards with more than 40 percent of employees had steadily increased since 1987. By 2002, 86% of companies used some type of performance incentive, and 61% used two or more plans with more than 40% of their work force. A variety of later surveys continue to establish the widespread use of incentives, but lower-level employees are the least likely to be covered and when they are covered, the percentage of pay at risk tends to be small (3-5% of base pay). About half of companies offer no non-exempt incentives, according to a 2014 WorldatWork/Deloitte survey. A small number of companies are heavy users. Based on various survey data, the author estimates that on average, a mere 1% of total rewards for front-line employees are performance incentives. That means that the approximate ratio of benefits to incentives is a shocking 30 to 1.

There are many types of equity-based plans. Some are benefits, such as stock purchase plans; most are Employee Stock Ownership Plans (ESOP), offered as retirement benefits – the rare benefit that is tied to company profitability and market value; a few plans are incentives, such as long-term stock grants and options plans. The National Center for Employee Ownership (NCEO) estimates that 28 million employees (about 18% of the workforce) are participants in at least one such plan.

Stock options have had a different history than other incentives. Usage in executive pay swelled starting in the 1980s as way of aligning executive and shareholder interests. Broad-based employee option plans became very popular during the booming stock market of the 1990s, and thousands of employees in companies such as Microsoft and

Qualcomm became millionaires via these plans. The party slowed for employees of large companies with a change in FASB accounting rules in 2004, which required stock options to be charged as an expense, and with post-Enron concerns that retirement plans were overinvested in company stock. NCEO data show the percentage of employees owning company stock dropped 18% and the percentage with options or grants dropped 29% between 2002 and 2010.

Equity is the most important part of the reward package for top executives in corporations, and are the single most important reason for the gap between employee and executive pay. However, even for executives there has been a pullback in stock option usage in the past 10 years, as Figure 4 shows. The ratio of executive to employee rewards is around 200 to 1, about half of its ratio at the peak at the height of the dot-com era.

Insert Figure 4 about Here

There is extensive research on many types of incentives. The results are consistent: incentives work most of the time, and have relatively strong effects on performance. However, there are a fair number of failures, and sometimes the failures are spectacular, as when leaders throughout the Veterans Administration hospital system collected performance bonuses while the system was failing to serve veterans.

The design and administration of incentive plans is complex. Many questions must be answered to develop a plan that is tailored to a specific organization. Should the plan reward individuals, teams, units, the company as a whole, or some combination? What degree of risk should the plan create, and how much should it pay out if performance is high? How should incentive opportunities vary across the organization? How will

management educate employees about how they can earn the incentive? How will the plan be maintained over time? The correct answers to these questions are those that best fit the unique business needs of the organization.

10. Governance becomes more prominent. The governance of reward systems was a quiet issue until recent years, and many changes have been gradual. Pay secrecy has become less of an issue as companies have conceded defeat to web technology. Sites such as Glassdoor.com and Vault.com and self-report salary survey sites provide extensive information about the reward system of major companies and occupations, arming employees with information that previously was unavailable to them. President Obama's recent announcement of tighter regulations preventing federal contractors (which include most large companies) from firing employees for disclosing their pay received little attention, partly because it was anachronistic. For executives, new legislation has greatly increased the formal responsibility and liability of Boards of Directors for executive pay. As a result, the Board, not the CEO, now typically hires executive pay consultants and Boards are less likely to rubberstamp the CEO's preferences.

Changes in reward systems, then, have been far reaching. The changes have affected the level of rewards offered, rewards models, and use of specific reward practices.

Why Have Rewards Practices Changed?

Two categories of factors explain why rewards practices have changed so much during the past 35 years. The previous section discussed micro forces affecting the practice of rewards, including the availability of market data, the rise of the consulting industry, and the emergence of new rewards models and practices. Here we consider macro forces that

affect the entire economy. Some forces are important primarily because they affect the level of rewards; others shape the types of rewards that companies offer.

Labor Supply and Demand

Labor supply that is greater than demand suppresses wages, because business does not need to pay as much to attract and retain workers. This was mostly the case from 1979-2013; the U.S. economy simply did not grow fast enough to absorb the 48% growth in the labor market. As Figure 5 indicates, unemployment remained high, never reaching the structural unemployment level that economists associate with rapid wage inflation. The unemployment rate was 4% or less for only 11 months from 1979-2013, when unemployment averaged just below 4% – a time when the “war for talent” was a fashionable conflict.

Insert Figure 5 about here

For well over a decade, the rewards profession has seemed out of step with business needs when so much of the rewards literature has focused on dealing with the next “war for talent” that always was just around the corner but never returned. Business leaders struggling with severe cost pressures have seen surplus labor in all but a few pockets where specialized skills were needed. They therefore ignored the recurring sales pitch of rewards professionals and their consultants, that new rewards programs were needed to prevent a future attraction and retention crisis.

Labor supply and demand ebb and flow, however. The war for talent is likely to become quite real again in the future. The BLS projects that labor force growth will slow from 1.3% in 1979-2000 and 1.1% in 2001-2010 to just 0.5% from 2012-2022, as the baby

boomers begin to retire. This suggests that companies will once again be forced to compete for talent in the labor market, leading to higher rewards costs.

Composition of the Workforce

Changes in the composition of the workforce have been important for wages. The steady rise of women in the workforce that began in the 1960s continued until it peaked and plateaued in 1999. The increased supply of labor, however virtuous in other ways, probably suppressed wage growth for the overall workforce. In addition, the rise in benefits costs, especially health care and work-life benefits, partly reflects the attempt to make companies attractive to prospective female employees. Recently, companies have found it difficult to control benefits costs because the most expensive benefits – health care and retirement – are the most attractive to aging baby boomers, the dominant demographic group. As the millennials becomes the dominant group at a young average age, it will be interesting to see if companies repackage rewards to address the usual preferences of younger workers for cash, time off, and career advancement opportunities.

Competitive Pressures

Competitive pressures negatively affect rewards because rewards are so important to the cost structure of most companies. Pressures on management to deliver profits have steadily increased over the past 35 years. Corporate owners have become increasingly impatient, as reflected in the shareholder activism, leveraged buyout, and private equity movements that began in the 1980s. The decreasing tenure of top executives has increased pressure for quick results. The steady decline of inflation during this period has magnified competitive pressures, since nominally small differences in costs and results have greater effects on relative performance in such an environment.

Globalization

Globalization has a negative effect on rewards in companies of developed economies that face global competition. Workers in developed economies can make in an hour what workers in developing countries make in a day or two.

There has been a stunning increase in global trade in the past 35 years, powered by an alphabet soup of multilateral and bilateral trade agreements – GATT, NAFTA, WTO, and so on. The U.S. has been an active participant in the sharp rise in world trade. The percentage of U.S. GDP that is represented by imports and exports has almost doubled, rising from 16.9% in 1978 to 30.4% in 2012. China's spectacular economic rise began in 1978 with Deng Xiaoping's announcement of reforms and the opening up of China, adding 300 million employees to the world economy – one of the most fundamental changes in the global economy in centuries. The increasing interdependence of the world's economies has increased global competitive pressures, forcing companies in the developed world to increase efficiencies and to cut costs severely. Those companies also have sought competitive cost advantage by investing in the developing world, partly to be closer to emerging markets and partly to take advantage of far lower wage levels. It has become easy for corporations to move work around the world as a result of shrinking tariffs, falling transportation costs, and growing communication and IT infrastructure.

Decline of Manufacturing Employment

Nowhere has the impact of global trade been greater than in manufacturing. BLS data indicate that manufacturing employment has been cut by more than half as a percentage of non-farm totals, from a high of 22% in 1977 to 9% in 2012. Entire industries of lower skill work, such as clothing and furniture manufacturing, have mostly disappeared

in the U.S. Many of those jobs have moved to China. During the past 25 years, China has gone from being the eighth largest manufacturing nation to number one, displacing the U.S. from the top spot that it held for decades.

Imports are significant but not the only factor in declining manufacturing employment. Increasing productivity has played a critical role. The analogy to agricultural employment is instructive. America was a largely rural economy until the late 18th century, and farms employed more than half of all U.S. workers as late as the 1880 Census. Mechanization reduced farm employment to only 1.5% of the workforce in 2013, and these workers produced vastly more than their counterparts of an earlier time. Similarly, automation and other methods of productivity improvement are reducing employment in manufacturing, even though the manufacturing sector is actually growing in terms of output. The average American manufacturer is more than three times more productive today than in 1975; indeed, output actually has more than doubled while employment has declined. Increasingly, manufacturing requires skilled workers who are not laborers but operators of complex technology. It is increasingly difficult for low skill workers to find jobs in a sector that once represented a stepping-stone to the middle class. Manufacturing jobs, according to U.S. Commerce Department data, pay a 17% premium over non-manufacturing jobs, making the loss of manufacturing employment opportunities especially painful for low-skill wage earners with few comparable alternatives.

Technology

New technology has instigated the creative destruction of jobs, companies, business models, and industries for centuries. Technology typically destroys the labor market value of jobs that are automated, while creating new, more highly paid positions that service and

operate the newer technology.

The impact of technology adopted since 1979 has had effects on jobs as pervasive as in any historical era. Technology has also been central to other forces that have impacted rewards, such as competitive pressures, globalization, and changes in manufacturing. Some observers are concerned that job losses due to new technology are so deep that workers cannot adapt – and that many may not be needed even if they try to adapt.

During the 1980s, companies focused on automating routine, low skill work. Tens of thousands of jobs disappeared in occupations such as bookkeeper, clerk, typist, secretary, telephone operator, bank teller, and assembly line worker. A new generation of IT appeared in the 1990s, and ever since has reduced the number of middle class employees. Thousands of positions were eliminated in occupations such as travel agent, retail clerk, utility meter reader, call center operator, repairer, warehouse worker, printer, librarian, mail processor, drafter, data manager, and stockbroker. Since 2008, high paid, high skill jobs have been the most strongly affected for the first time. Figure 6 shows an alarming drop-off in labor force participation since 2008. The retirement of the baby-boomers does not explain this drop, in part because most boomers do not want to quit working and most cannot afford to do so. More likely, many of the long-term unemployed from a wide spectrum of skill levels have simply given up hope of finding work.

Insert Figure 6 about here

It seems unlikely that any occupation will escape the future effects of technology, big data, artificial intelligence, and automated analytics. The work of engineers, call center operators, programmers, and business analysts is already shipped around the world over

the web, making it possible for work to continue 24/7 and enabling companies to take advantage of lower wages elsewhere. Current efforts envision technology replacing many doctors, consultants, and college professors – among the most highly skilled occupations.

Rout of the Union Movement

The decline of the union movement also has suppressed wages. Union shrinkage is related to the decline of employment in manufacturing, the union home base. But reduced government support for labor unions, the growth of employment in right to work states, and changing societal attitudes have had negative effects as well. The statistics are arresting. From its high in 1954, when 35% of U.S. employees were union members, the decline has continued until only 11% belong to a union. Notably, the percentage of private sector employees that belong to unions has dropped to just 6.7%. A third of public sector employees are union members, a percentage that has been fairly constant for decades. However, recent challenges to union contracts perceived as excessive in many states and municipalities, including former union bastions such as Wisconsin, Illinois, and Michigan, may erode future union power and membership in government.

Regardless of one's views of unions, it is hard to disagree that the decline of unions has had a negative impact on employee rewards. Labor economists estimate that union members average about a 15% wage premium, plus they enjoy premium benefits. The suppression of employee rewards in the economy as a whole is partly the result of the movement of fully one-quarter of the workforce from union jobs to the non-union jobs in the space of a few decades.

Regulatory and Legislative Changes

The regulatory and legislative changes of the past 35 years have had mixed effects

on rewards. Reducing discrimination based on gender and race has had positive effects on social justice, while making compensation administration more complex. Increases in the minimum wage at the federal, state, and local levels (such as Seattle's new \$15 minimum wage) have been a public response to slow wage growth, especially at the bottom end of the ladder. Federal and state enforcement of wage and hour laws has increased wages by declaring new worker categories non-exempt from overtime requirements, and reclassifying "independent contractors" to employee status has given overtime coverage and benefits to some workers.

Many regulatory and legislative changes have had negative implications for rewards. As we have seen, legislative and regulatory changes have hastened the decline of pensions and employee stock options. The deregulation of the airline, telecommunication, and trucking industries has reduced prices for consumers but also has sharply reduced pay for employees in those industries. Early indications are that the Affordable Care Act will have negative effects on health care benefits.

Summary

Several forces have combined to stagnate the total rewards earned by American workers during the past 35 years. Competitive pressures have stiffened executive resolve to limit reward increases, while excess supply of labor and the low bargaining position of workers have made it less necessary for employers to raise wages to fill job openings. Stagnation may give way to inflation in the next decade, however, due to lower labor supply and legislative solutions such as higher minimum wages.

What Changes Are Needed in the Future?

This article concludes with a call to action, in the form of five design principles for

future reward systems. This moves from the discussion from “what is” to “what should be.” The author’s decades of research and practice inform these prescriptions, but ultimately they are a personal statement. Consistent with the view no reward design fits all, the prescriptions that follow apply to profit-making firms – not necessarily to government and not-for-profit organizations. For the latter, current rewards design are more appropriate.

1. Business Leaders Must Lead on Employee Rewards

Today, business leaders tend to overemphasize the goal of cost control goal for rewards. The desire to reduce the largest cost facing most companies is understandable. However, keeping rewards costs low is a tactic, not a strategy. It will not provide a sustainable competitive advantage when the overwhelming majority of companies are doing the same. Business leaders need to think more deeply about how various rewards fit their unique configuration of business needs, and how to differentiate reward levels and practices throughout the organization. Congruence models of reward system effectiveness such as Figure 1 may help stimulate some ideas.

Experience suggests that when business leaders withdraw attention from rewards, rewards professionals have difficulty filling the vacuum with impactful innovations. The instincts of most rewards professionals pull them toward conservatism, copying others, and uniformity rather than differentiation. Interestingly, many important reward innovations of the past 50 years are the creation of business leaders, including the Silicon Valley model, skill-based pay, and unit incentive plans. It is time for business leaders to again view rewards as their responsibility, and to get creative in using rewards for competitive advantage.

2. Rewards Design Needs an Investment Perspective

Relentless cost control focus in rewards design prevents leaders from viewing rewards as investments that can generate a positive return. Rewards costs should be viewed like other major business costs. Leaders do not think that the best capital investment is the cheapest, regardless of how it performs. Similarly, the best reward system is not always the cheapest. The investment analysis must begin with whether rewards are meeting business needs, and if not what the costs and benefits of various options might be. The best option may cost less – or more. Moreover, business leaders too often confuse total rewards costs with average wage levels. A system with fewer, more highly paid employees can be less expensive but more effective than a conventional system.

3. Reverse the Benefits Revolution

Organizations would be more effective and employees would be more engaged if a large portion of benefit costs were converted to wages and especially to incentives. This proposition is likely to be controversial, but it follows from the evidence.

The first problem is that benefits costs are grossly inconsistent with the espoused goals of most reward systems. Benefits costs on average are about 30 times the cost of incentives for front-line employees, making a mockery of claims that organizations pay for performance. Benefits are entitlements. Employees receive the same health insurance and retirement plan whether they perform well or badly.

Second, considerable evidence suggests that employees do not understand or care about the economic value of their benefits, despite efforts to educate them. Most prefer higher wages to benefits even if informed about benefit value. A 2003 Sibson Consulting study directed by the author found that for the average American worker, salary increases had 2.7 times the value of retirement benefits, performance bonus opportunities were 4

times as valued as retirement benefits, and stock grants were 20 times as valued as retirement benefits. Younger employees especially place low value on health care, because they are rarely sick, and retirement benefits, because retirement seems like a distant dream. Why fight employee preference?

The author takes a dim view of work-life benefits in particular. There is little meaningful evidence of their value; this emperor has no clothes. Worse, these benefits multiply the administrative burden with many small programs, they distract from more important reward system goals, and they send the wrong messages about the employer-employee relationship. A more appropriate message is, your employer is your employer. Your employer is not your doctor, investment advisor, lawyer, chef, fitness instructor, bartender, veterinarian, or social director. Asking companies to be responsible for so many things outside of their core business competence adds unnecessary cost that employees do not fully value and weakens the focus on performance.

One approach to cutting benefits costs would be to create truly flexible benefits plans that allow employees to choose the benefits that matter to them. Today, nearly all employees receive almost all benefits, making benefits expensive. If employees prefer to take all of their benefits in the form of health and retirement while minimizing vacation, massages, and pet insurance, so be it. Employee choices would be fascinating, and probably would maintain a relatively high level of satisfaction while reducing costs. This is consistent with the individualized organization approach advocated by Lawler in this issue.

4. Increase Investment in Pay for Skills and Knowledge

Skill-based pay is underused as a way to increase the development of employee capabilities in an era in which continual learning and development are needed. Skill-based

pay may never fulfill the hopes many had for it to replace job based pay systems, but nevertheless its use is likely to expand in the future. Clearly, there are many areas of the economy in which there are serious skill gaps, despite high unemployment in the economy as a whole. Pay for skills can help address such gaps, and can help prevent gaps in the first place by incenting employees to build skills in emerging areas of need.

Two modifications to current practice may help. First, the typical corporate competency system is not a good basis for rewards. Competencies such as “influencing others” and “customer orientation” are too generic, too nebulous, and too fluffy to build a pay system around them. The most useful pay for skills systems are oriented toward primarily toward hard technical skills that can be identified and measured with some precision. Second, skill-based bonus pay deserves far wider use. It can be very flexible and nimble in rewarding an ever-shifting mix of needed skills, and it has a far lower administrative burden than the base pay systems of the past.

5. Increase Pay for Performance – In Whatever Forms Best Fit the Organization

Almost every employee in the organization should be part of an incentive plan that has a payout opportunity of at least 5%, and preferably 10%, of base pay. The percentage of pay at risk should increase as organizational level and base pay increase, and certain types of positions (such as executives and sales) typically should have a relatively high percentage of their direct compensation at risk.

Pay that varies based on performance is extremely attractive in the current business environment. This makes for a more flexible reward mix in which employees make more if they earn bonuses, but compensation costs are lower if performance is low and there are no bonuses. Incentives create a performance culture, not an entitlement culture.

The design and administration of incentive plans is complex, and the difficulty discourages many organizations from adopting new plans. There indeed are many challenging questions to work through in meeting the business needs of the organization. Yet, the research evidence convincingly shows that employee incentives tend to increase performance, and the effects often are very strong. The difficulty of designing and maintaining employee incentives should be a reason to adopt them, not a reason to avoid them. The difficulty of doing incentives well holds the key to their potential competitive advantage. Incentives are difficult for competitors to imitate, and they usually fail if they simply copy the incentives of others without laying adequate groundwork. Companies succeed by receiving ongoing executive support for incentives, creating good learning processes to discover what works best, and having enough focus to maintain the employee education, involvement, communication processes needed to make the plans work.

Implications

If these recommendations were accepted, reward systems might look radically different. Suppose executives decide to spend the same amount as before on total rewards, but to significantly reallocate expenditures. The company might adopt a barebones benefit package and spend only half as much on benefits as is typical today. On average, that would free up 15% of total compensation dollars for reallocation to other uses. The company might use part of that amount (perhaps 5% on average) to reward the kind of ongoing skill development needed to keep the skill profile of the workforce in line with the emerging needs of the company. That would leave 10% of total reward dollars available for employee performance incentives – a tremendous expansion of incentive opportunities for the average employee.

Consider two companies that are identical in every way except that one has a conventional reward package and one has the profile prescribed here. Which company is likely to better to attract and retain talented employees, especially performance-oriented employees? Which company would generate higher reward satisfaction, and a more engaged workforce that is attuned to the needs of the business? Which would have higher performance? Which would be the better investment for shareholders? The author's research and experience leads to the conclusion that the company with the new reward system would win convincingly.

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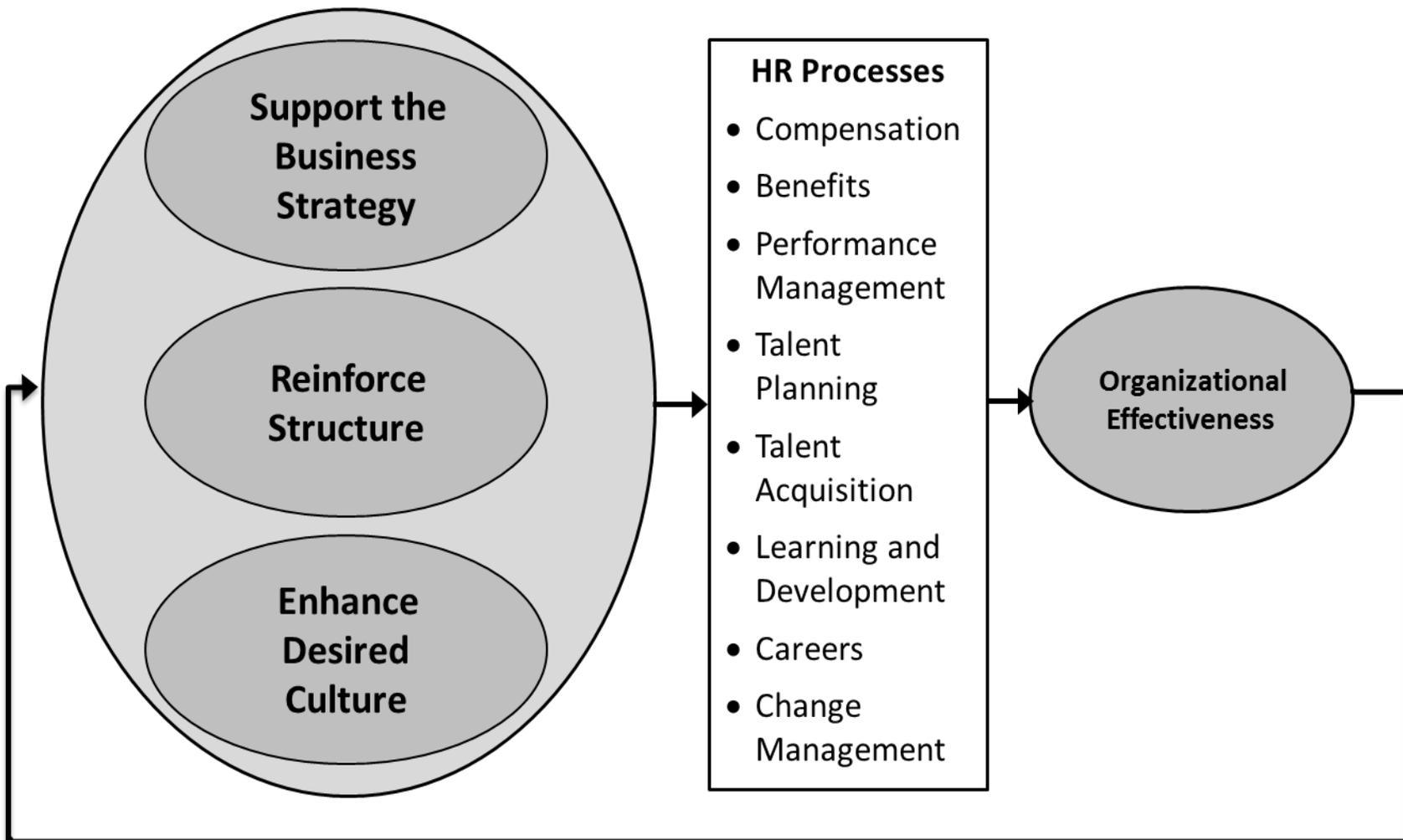
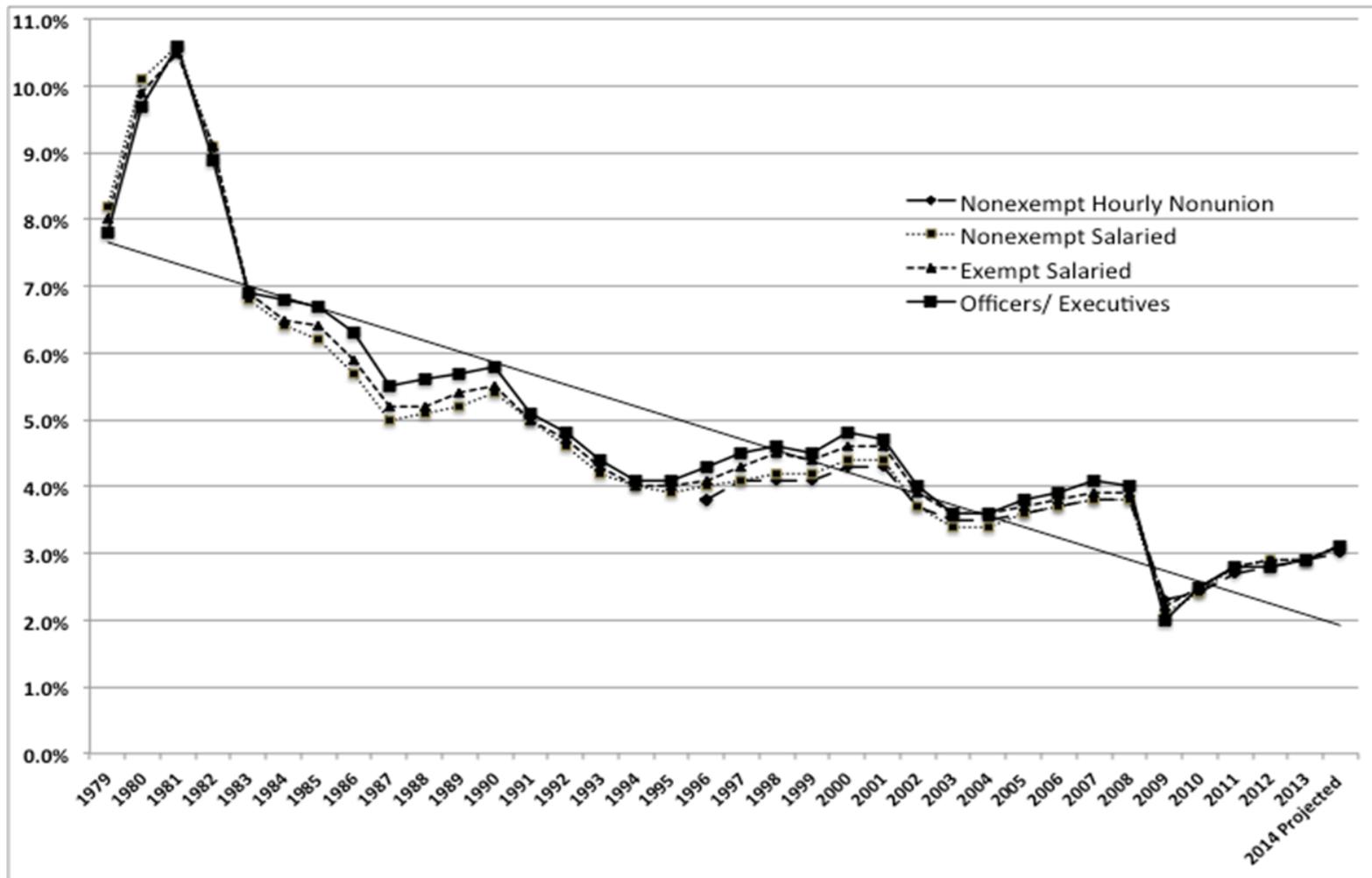
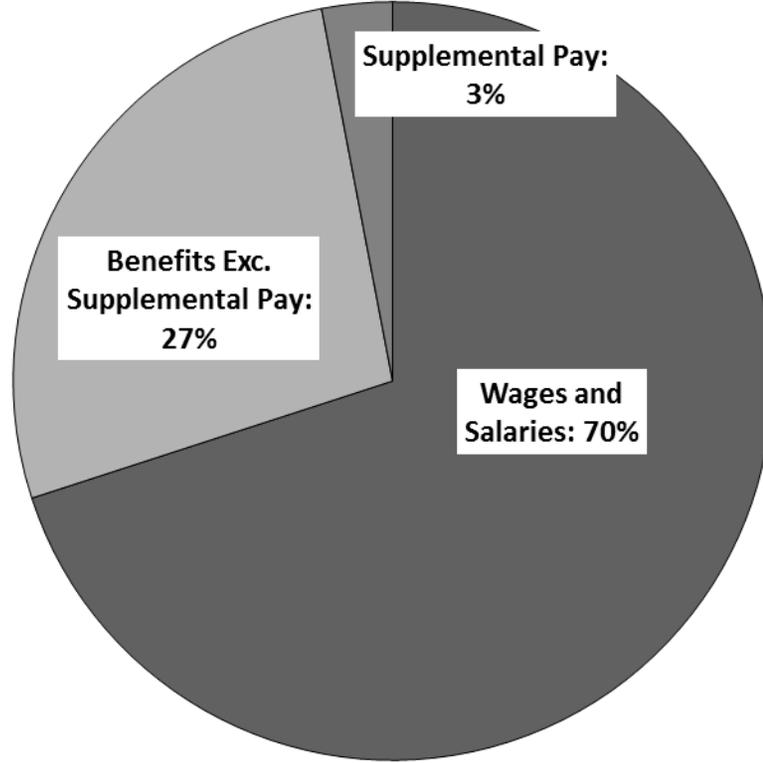


Figure 1: CEO Congruence Model of Rewards Effectiveness



Source: WorldatWork 2013-2014 Salary Budget Survey

Figure 2: Salary Increase Budgets, 1979-2014



Source: U.S. Bureau of Labor Statistics, Employer Cost for Employee Compensation (ECEC) Series, December 2013

**Figure 3: Relative Cost of Rewards to Private Sector Employers
December 2013**

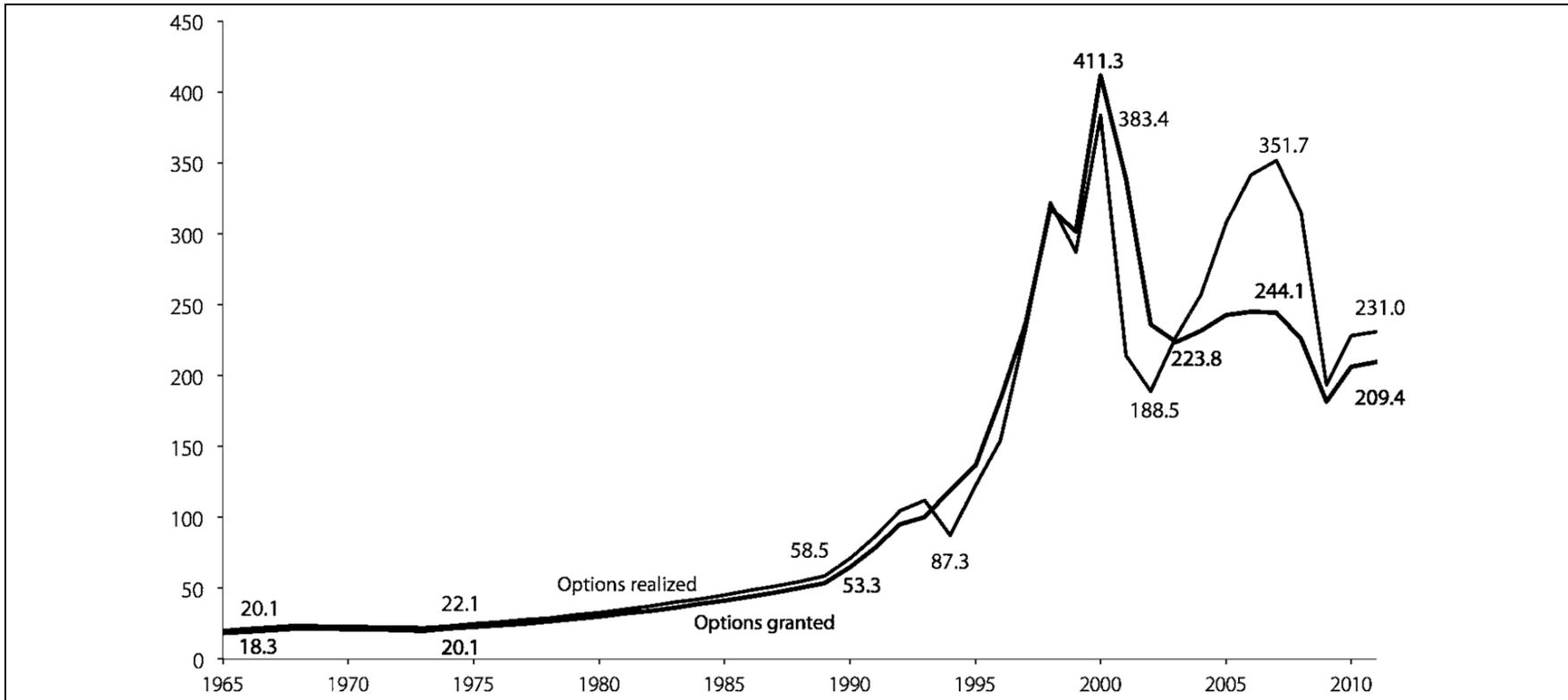
	1986	1989	1992	1995	1998	2001	2004	2007	2010	2013	28-Year Growth
Total Cost per Hour Worked	\$13.25	\$14.28	\$16.14	\$17.10	\$18.50	\$20.81	\$23.90	\$26.42	\$27.75	\$29.63	124%
Wages and Salaries	\$9.67	\$10.38	\$11.58	\$12.25	\$13.47	\$15.18	\$17.02	\$18.67	\$19.64	\$20.76	115%
Total Benefits	\$3.58	\$3.90	\$4.55	\$4.85	\$4.94	\$5.63	\$6.88	\$7.75	\$8.11	\$8.87	148%
Benefits as a Percent of Total Compensation	27%	27%	28%	28%	27%	27%	29%	29%	29%	30%	
Benefits as a Percent of Wages and Salaries	37%	38%	39%	40%	37%	37%	40%	42%	41%	43%	
Cost of Specific Benefits:											
Insurance	\$0.73	\$0.85	\$1.12	\$1.15	\$1.10	\$1.28	\$1.70	\$2.01	\$2.22	\$2.45	236%
Legally Required	\$1.11	\$1.27	\$1.47	\$1.59	\$1.63	\$1.73	\$2.08	\$2.22	\$2.28	\$2.43	119%
Paid Leave	\$0.93	\$1.00	\$1.09	\$1.09	\$1.16	\$1.37	\$1.53	\$1.79	\$1.89	\$2.05	120%
Retirement	\$0.50	\$0.42	\$0.46	\$0.52	\$0.55	\$0.62	\$0.88	\$0.95	\$0.97	\$1.10	120%
Supplemental Pay	\$0.30	\$0.34	\$0.39	\$0.47	\$0.56	\$0.62	\$0.66	\$0.79	\$0.75	\$0.85	183%

Source: U.S. Bureau of Labor Statistics, Employer Cost of Employee Compensation Historical Listing

Notes:

1. Insurance overwhelmingly represents health insurance (for example, 94% of Insurance in 2013)
2. Legally Required benefits include Social Security, Medicare, Unemployment Insurance, etc.
3. Supplemental pay includes premiums for overtime, holidays, and weekends; shift differentials; and nonproduction bonuses

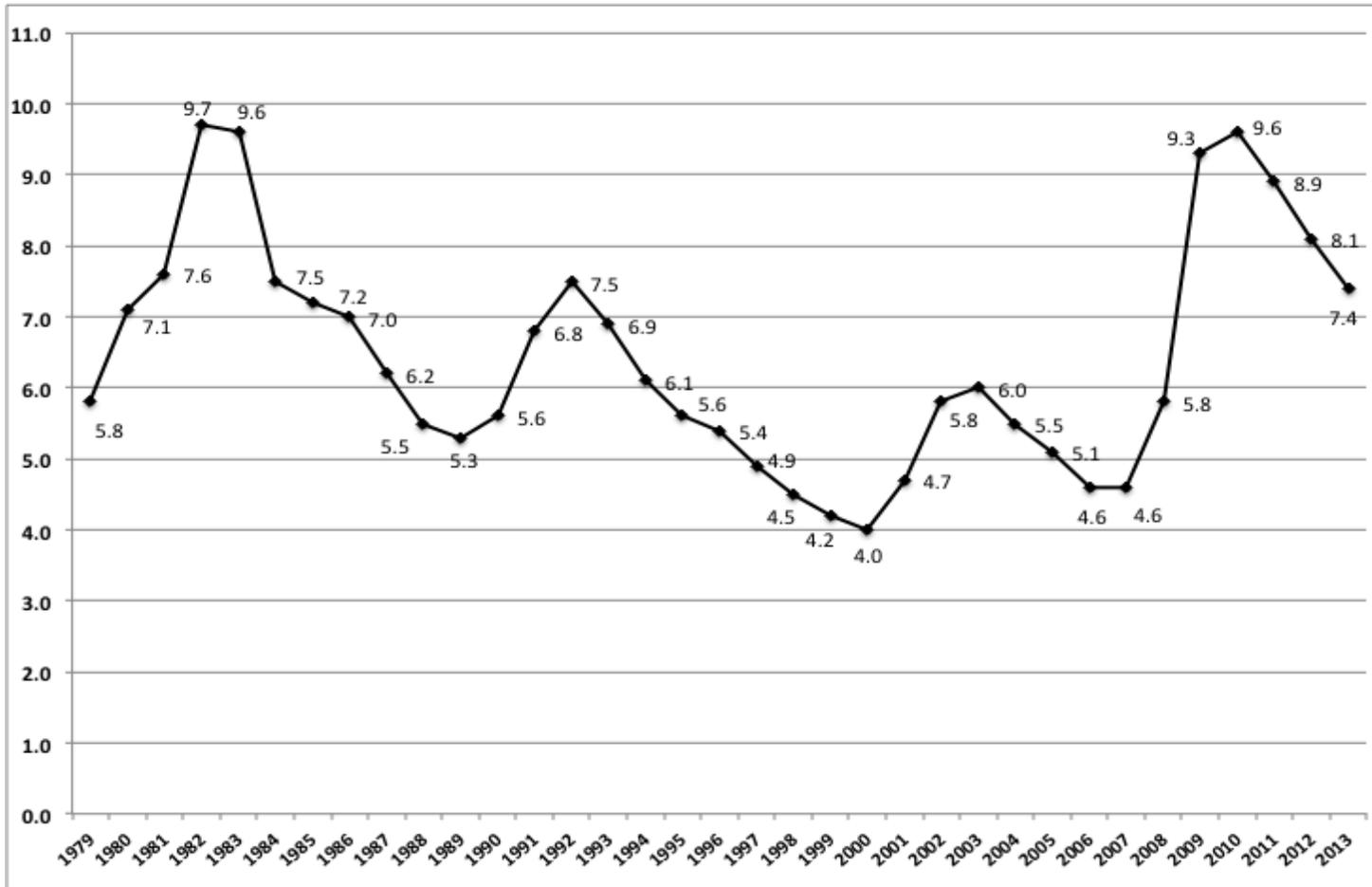
Table 1: Private Industry Employer Costs for Employee Compensation



Note: "Options granted" compensation series includes salary, bonus, restricted stock grants, options granted, and long-term incentive payouts for CEOs at the top 350 firms ranked by sales. "Options exercised" compensation series includes salary, bonus, restricted stock grants, options exercised, and long-term incentive payouts for CEOs at the top 350 firms ranked by sales.

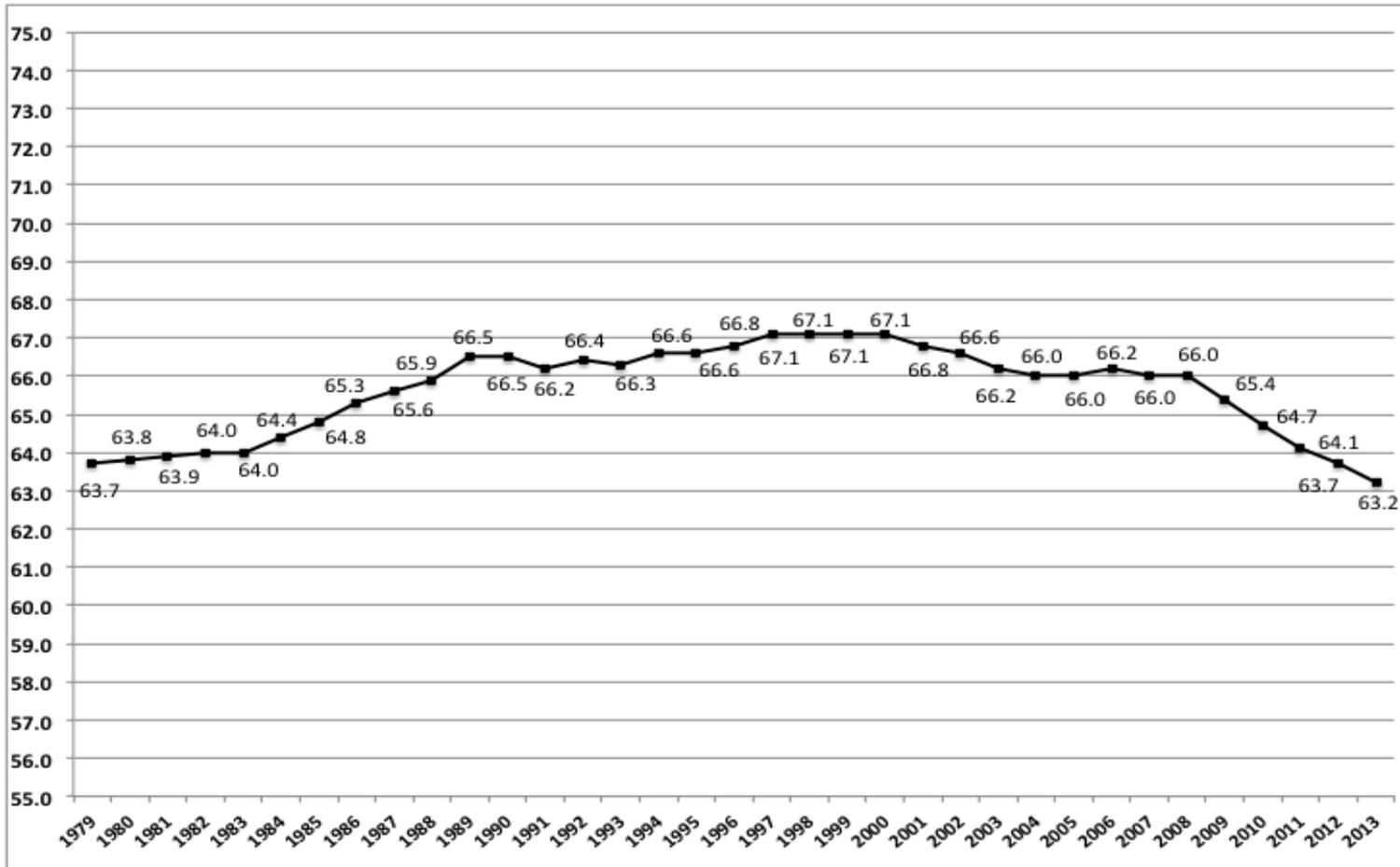
Source: Mishel and Sabadish, 2012

Figure 4: CEO-to-Worker Compensation Ratio, with Options Granted and Realized, 1965–2011



Source: U.S. Bureau of Labor Statistics

Figure 5: Annual U.S. Unemployment Rate, 1979-2013



Source: U.S. Bureau of Labor Statistics

**Figure 6: U.S. Civilian Labor Force Participation (Percentage of Working Age Population Employed)
1979-2013**

Biography

Gerald E. Ledford, Jr. is Senior Research Scientist at the Center for Effective Organizations (CEO), Marshall School of Business, University of Southern California. His areas of research focus include total rewards, employee engagement and involvement, the design of work, and large-scale organizational change. He recently has focused on the effects implications of new HR information technology (HRIT). He returned to CEO in 2012, where he was a key contributor from 1982-1998. From 1998 to 2003, he held leadership positions at Sibson Consulting. Since 2004, he has been President of Ledford Consulting Network LLC. He received a Ph.D. and M.A. in Psychology from the University of Michigan. Gerry has authored over 100 articles and ten books and he frequently speaks at professional events.