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The Future of Employee Compensation: Compensation Café Entries

CEO Publication
G14- 11 (645)

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December 2014

Executive Summary

This collection is a three-part series that appeared in Compensation Café, the leading blog on reward systems, from December 1-3, 2014. See www.CompensationCafe.com for the original entries and reader responses to them.

Part I discusses the current stagnation in the field of employee compensation. Parts II and III summarize key themes from a recent article: Gerry Ledford, The changing landscape of employee rewards: Observations and prescriptions, Organizational Dynamics, 2014, 43, pp. 168-169. Part II examines trends in employee rewards over the past 35 years and the causes of those trends. Part III argues for a specific set of changes in employee rewards in the future.

Part I
Malaise in employee rewards: What's going on?

As one who has researched employee rewards for well over 30 years, it is my considered opinion that this field has gotten stagnant and, well, a bit dull. In talking to veteran practitioners from companies in a wide range of industries, I am struck by a sense of depression that today seems to lurk just under the surface for many (certainly not all) practitioners.

My comments here are confined to employee rewards, not executive or sales rewards. Executive rewards have constantly evolved due to shifting legal and regulatory demands. Sales compensation has always been a different beast: it has different buyers and economic cycles than employee rewards, and sales incentives constantly evolve to meet new business needs. Much less in employee rewards is enlivening or new.

For contrast, let's remember what I consider to be the Golden Age for employee rewards: the late 1980s to about 2001. During this period, there was tremendous ferment and excitement in the field. Some of the innovations of this era are still with us today and distinguish contemporary employee rewards from practices of the 1970s and before. These include changes in the level and mix of benefits, widespread use of incentives for employee performance, commonplace use of pay for skills and competencies, and the emergence of the Silicon Valley model of rewards. Other changes were interesting but were dead ends, such as broad banding, or were derailed by regulatory changes, such as stock options for all employees. Overall, there was a remarkable level of experimentation in organizations large and small that is not happening now.

If employee rewards practices are in a rut and its practitioners are depressed, why might this be so? I see four key reasons.

1. **Strategic irrelevance.** The recent Mercer Total Rewards Survey found that that only a third of respondents say that total rewards and business strategies are fully aligned. I think the prime culprit is practitioner obsession with benchmarking as the key to rewards design. Benchmarking is the antimatter of strategic thinking. It asks how we can look like everyone else. Strategic thinking asks how we can gain strategic advantage by being different. Far too few rewards professionals are able to discard the crutch of benchmark thinking.

2. **What's the Next Big Thing?** The search for the Next Big Thing is obsessive among practitioners and consultants. The NBT promises status and security to practitioners and a revenue stream to consultants. For years, we have seen the repackaging and relabeling of old ideas to sell them as new and fresh. A true Next Big Thing is not on the horizon; nothing very new in employee rewards has emerged in over a decade.

3. **Declining number of rewards professionals**. The Bureau of Labor Statistics reports that between 2008 and 2013, 55% of the Compensation and Benefits Manager positions

in the U.S. disappeared. This is shocking. Several factors are at play. The lack of innovation in rewards has made it possible to get by with fewer managers. Like everyone else in the corporate world, rewards professionals work harder than they used to. Some positions have been outsourced, although there was no stampede toward rewards outsourcing in this period. Finally, new software has automated and eliminated many jobs.

4. **Technology as a game changer.** New HR technology is bypassing rewards professionals and putting information directly in the hands of managers who make decisions. Already, supervisors routinely get information about where each employee they review stands versus the market (with all market analysis done automatically and behind the scenes) and predictions about who is at risk of quitting. Supervisors can use that information to adjust raises and bonuses with no help from rewards experts. Executives get analytic information on how rewards costs in the company compare to those of competitors. Complaining that the data are not so simple and require careful interpretation is like shouting into a strong wind.

The net result is rewards practices are not changing very much. There is a serious risk that executives will see rewards professionals and the cost of rewards themselves as just another burdensome cost, not an investment that pays dividends. This is a very dangerous situation for the rewards profession.

Part II of this series will look at the changes in the rewards field over the past 35 years to see how we have arrived at this state of affairs. Part III will review some prescriptions for new directions in the rewards field that would create a more vigorous direction.

Part II
Employee rewards: Where are we and how did we get here?

Nine changes during the past 35 years have shaped contemporary employee rewards.

1. Rewards design: Market facing. Practice has shifted profoundly from an inward on the internal value of jobs (for example, through point factor systems) to an outward focus on the market value of jobs. This was fueled by the tremendous expansion in the availability of market pricing data that is collected by consulting firms. The message to employees: If you want more money, develop capabilities that the market wants.

2. Strategic rewards design: Ebbing and flowing. The core rewards technology of market pricing encourages us to worry about what others do. However, strategic design requires departing from standard practice to find competitive advantage in practices that better meet business needs. The peak era for strategic design was in the late 1980s to about 2001. Copying others was much more the norm before and after that era. Strategic rewards design today is mostly an unpracticed ideal.

3. The Silicon Valley model: In full bloom. Silicon Valley technology developed a new rewards model in the 1980s, and it remains the most radical departure from standard practice in widespread use. It appears to offer more of everything: base pay, benefits, incentives (including equity), and work-life benefits. The model is widely admired but poorly understood. Observers often fail to recognize that Silicon Valley is the most competitive labor market in the country; that companies modeling these practices are among the most profitable on the planet, so they can afford it; and that work-life rewards are not motivated by management largesse but by the desire to keep employees productive and at work as many hours of the day as possible.

4. Base pay increases: Steadily shrinking. There has been an almost linear drop in base pay increases since 1981, when average wages increased 10%, to today's raises of around 3%. Wage increases have barely outplaced inflation during the past 35 years.

5. Benefits costs: Rising. The quaint term of art in 1978 was "fringe benefits." From 1986 to 2013, benefits increased 148%, while wages increased 115%. By 2013, benefits represented 30% of total rewards for employees (or 43% of the value of base pay). This is problematic; the average employee does not value benefits nearly as much as cash.

6. Pensions: Disappearing. Retirement plan coverage has hardly changed, but the form has shifted from defined benefit to defined contribution. Pensions reached a high in 1980, covering 46% of private sector workers. The first defined contribution plans were created in that year, and adoptions have increased ever since. By 2013, only 16% received pensions and pensions' demise is on the horizon.

7. Work-life: Rage of the age. Almost every company offers some work-life benefits today. The annual "best places to work" competitions are an arms race of exotic benefits.

Vendors are numerous and aggressive. This is the most widely publicized component of the Silicon Valley model and the easiest to copy. Usage grows even though evidence of efficacy and ROI is appallingly weak.

8. Pay for skills: Becoming commonplace. Surveys suggest that the use of pay for skills, knowledge, and competencies has penetrated widely but not deeply in the private sector, and most companies use it somewhere. This type of plan provides an answer to chronic shortages of some key skills by rewarding employees for the systematic development of skills that companies need.

9. Incentive pay: Restrained growth. Incentives for non-management employees, once rare, have grown steadily over the years. Still, users are cautious in the percentage of employees covered and in funding levels. My best estimate is that the average incentive payout for American employees is 1% of salary, with of course tremendous variation. This means that the ratio of benefits to incentives is 30 to 1, making laughable managers' commitment to paying for performance.

Why Have Rewards Practices Changed In These Ways?

Many forces have converged to shape rewards in recent decades. Vastly increased pressure on executives to deliver results has created constant pressure to hold the line on rewards. Competitive pressures have led to market orientation in rewards, more use of skill-based pay and incentives, interest in low-cost work-life benefits, and the decline of pensions.

Excess labor supply has reduced employees' bargaining power. Unemployment has sunk below 4%, indicating a tight labor market, for only 11 months out of the past 420, and all of those were 15 years ago or more. Causes of labor oversupply include the entry of the large baby boomer generation into the workforce, the addition of many more women to the workforce, the automation of jobs throughout the economy, the decline of manufacturing employment, and offshoring of labor-intensive work of all kinds. The rout of the union movement has not helped employees. Little wonder that the most significant new model of rewards, the Silicon Valley model, arose in a part of the economy with a very different labor market and competitive pressures.

We have reviewed where employee rewards are and how we got there. The next section of this series asks, what should we do next?

Part III
Where Should We Take Employee Rewards in the Future?

Here, I argue for five major changes in employee rewards over the next decade.

1. Business leaders must lead on employee rewards. Since the recession of 2001, business leaders have made cost control their primary goal for rewards. This is weak strategy. Business leaders need to think more deeply about how rewards can be used to provide competitive advantage. This means thinking about how rewards can reinforce business strategy, structure, and the desired culture. Historically, business leaders have created many rewards innovations. Examples include gainsharing, skill-based pay, profit sharing, broad-based employee stock ownership, and the Silicon Valley model.

By contrast, consultants excel at packaging, selling, and diffusing "best practices," that is the innovations of others, while rewards professionals are best at developing and implementing detailed designs. The profession is naturally conservative; the core technology of market pricing encourages an overemphasis on what others are doing. Also, pay is an emotional issue, and few rewards professionals have the organizational standing to enact changes that may be initially unpopular or difficult.

2. Rewards design needs an investment perspective. It is surprising that rewards are so rarely considered an investment. Executives would never spend billions in technology or materials without demanding creative thinking about the optimal choices as well as rates of return. Such questions are asked far too rarely about rewards. Taking an investment perspective might liberate thinking about options. Sometimes the best investment for a given employee population is the cheapest, and sometimes it is the most expensive; it depends on the design options and rates of return.

3. Reverse the benefits revolution. Benefits have grown steadily as a percentage of total employee rewards, and they now represent 30% of total rewards cost. Organizations would be more effective and employees would be more engaged if at least half of benefits dollars were converted into cash, especially incentive opportunities. Why?

First, benefits go to all, regardless of performance. When benefits represent 30% of total employee rewards and performance incentives are about 1%, management claims of pay for performance are laughable. Second, most employees strongly prefer cash to benefits. Why fight this? This is especially true for younger employees who are about to become the dominant employee group. Third, meeting social needs is not what business does best or should necessarily do at all. Companies should focus on performance, not becoming the employee's doctor, investment advisor, fitness instructor, lawyer, chef, and social director.

4. Increase investment in pay for skill and knowledge. Skill-based pay is underused for developing employee capabilities in an era that demands continual learning and development. Two modifications to typical plans may encourage greater use. First, plans should focus on technical skills specific to employees' work. Typical corporate competency systems are too generic and nebulous to have compelling business value. Second, bonus pay systems deserve far wider use, because they are nimble and less burdensome to administer than base pay systems.

5. Increase pay for performance. Almost every employee should be part of an incentive plan that has a payout opportunity of 10% of base pay. In most organizations, only managers and sales have high levels of pay for performance today. Contrary to the popular claims, research overwhelming shows that incentives usually increase performance and do not have negative effects. However, incentives are difficult to design, implement and maintain. Although this discourages many companies from using incentives, it should be considered a reason to use them. Companies gain competitive advantage by accomplishing difficult things that are hard to copy. Employee incentives fit that bill.

Implications

What would be the impact of changing rewards in these directions? Consider two companies that are similar except for their employee rewards programs (but they have the same total rewards cost). Company A has a conventional reward system, while Company B implements the changes recommended here. It allocates 15% of total rewards for benefits, 10% on average for employee incentives, and 5% for reinforcing skill development.

Which company do you think would be more likely to attract and retain talented, performance-oriented employees? Which company would have higher rewards satisfaction, employee engagement, involvement in the business, and dedication to meeting customer needs? Which would make a better investment? Company B would win on all of these criteria. What are we waiting for?