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PART 1:3

WHAT RECENT ACADEMIC STUDIES SAY ABOUT COMPENSATION DESIGN

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Four studies examine the process of compensation design.

There are numerous critical decisions that compensation professionals must make when designing a compensation system. These include fundamental decisions like what the basis of pay should be; what the pay mix should be; how much, if any, pay for performance; and what the measure of performance should be. This article includes four studies that look at how these fundamental aspects of compensation system design affect employee attitudes and behaviors, and ultimately organizational performance.

The first study addresses the fundamental question, "What should the basis of pay be?" It compares the performance and employee attitudes of firms using skill-based, job-based or market-based plans. The second and third studies look at the effects of different pay mixes, focusing on the level of pay for performance, which leads to less egalitarian systems. The final study looks at the effects of different measures of performance in team-based rewards. In aggregate, these studies show that differences in pay systems have substantial effects on employee and companywide performance.

1 A Comparative Examination of Traditional and Skill-Based Pay Plans

By A. Mitra and J.D. Shaw, published in the *Journal of Managerial Psychology*, 2011

This study examined the differences in employee attitudes, employee behaviors and subsequent organizational performance among organizations that use skill-based, job-based or market-based pay plans. By obtaining data from 214 companies, the study looked at:

- Employee attitudes, such as employee satisfaction and commitment
- Employee behaviors, such as turnover and absenteeism
- Company productivity, such as output and production bottlenecks
- Workforce flexibility measures, such as adaptability of employees, flexibility in job assignments, employee capability for self-management and employee versatility.

The study also looked at how these factors affect the perceived success of the pay plan and how the consistency of the pay plan with organizational elements like culture and management style affect these relationships.

Findings | The study found that organizations with skill-based pay plans were more likely (than those with job-based or market-based plans) to have greater levels of workforce flexibility and because of the greater flexibility, greater productivity. Similarly, the study also found that organizations with skill-based pay plans were more likely to have more satisfied and committed employees, resulting in lower turnover and less absenteeism.

Lastly, the study found that greater productivity, reduced turnover and lower absenteeism were all related to the perceived success of the pay plan (for all types), but only if the pay plan was consistent with the organization's culture and management style.

The Bottom Line | Skill-based pay plans tend to lead to more positive employee and firm outcomes than job-based or market-based plans. Better employee attitudes, less absenteeism and turnover, and increased organizational productivity and flexibility were all found when comparing skill-based plans to the others. However, the success of the plan also depends on the plan's fit with organizational elements, including the company culture and management style. Compensation professionals can expect better outcomes with skill-based pay plans; however, skill-based plans usually cost more than job-based or market-based plans. Thus, in situations such as a poor fit with the company culture, style, type of jobs or strategy, the costs probably outweigh the benefits and should be carefully considered.

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2 Compensation Policy and Quit Rates: A Multilevel Approach Using Benchmarking Data | By C. Riddell, published in *Industrial Relations*, 2011

This study looked at how greater differences in base pay among employees at the same and different levels affect quit rates in organizations. The study also investigated whether quit rates are affected by other compensation factors, such as being bonus eligible, pay relative to the market, the presence of a job evaluation-based system, team-based pay and merit-based pay. Furthermore, the study looked at factors that affect the strength of the relationship between pay dispersion and quit rates.

Findings | Greater differences in base pay among employees strongly affect quit rates in organizations, particularly when those differences are at the same organizational level. Paying above the market leads to substantially lower quit rates. Also, employees that were bonus eligible were less likely to quit. However, other compensation factors, such as the presence of a job evaluation-based system, team-based pay and merit-based pay, were not found to be related to quit rates. Finally, greater differences in base pay among employees lead to more quitting in firms when the firms use team-based compensation.

The Bottom Line | Paying above the market always leads to less turnover, while other compensation aspects may or may not affect quit rates depending on their design and implementation. Thus, the most fail-safe way to reduce turnover through compensation is to increase base pay. Greater pay differences among employees at the same organizational level of the company leads to substantially higher turnover, especially if they are part of a team-based plan or not bonus eligible. So pay differences among employees in the same pay grade should be well-justified and seen as necessary to signal to employees what the company values. Although greater differences will lead to more employees quitting, it should be noted that this may not necessarily be a bad thing if it is the poor-performing employees who quit.

3 The Effect of Relative Compensation Dispersion of Firms on the Mobility and Entrepreneurship of Extreme Performers | By S. Carnahan, R. Agarwal and B. Campbell, published in *Academy of Management Best Papers Proceedings*, 2011

Following logically from the previous study, this study looked at how a company's pay dispersion relative to competitors affects the turnover of high-performing and low-performing employees. That is, do greater pay differences among employees at a firm affect the quit rates of high- and low-performing employees differently? The study also looked at the subsequent employment of those who quit, and explores which employees are most likely to start a new business in competition with the employee's previous firm.

Findings | Consistent with previous research, this study finds that greater pay dispersion leads to generally greater turnover. However, under conditions of high pay dispersion, low performers are much more likely to leave than high performers, while under conditions of low pay dispersion high performers are much more likely to quit than low performers. Furthermore, high performers who quit are much more likely to start a competing business than low performers who quit. These findings are consistent with other research that suggests that employees want to be paid for performance, and when they are not, it is the high performers who seek greater opportunities.

The Bottom Line | Although greater pay differences among employees will lead to more employees quitting, it is likely to be the lower-performing employees who quit. Thus, compensation professionals should be sure that pay differences are justifiable, particularly among those in the same job. Performance differences should be reflected in pay differences or high-performing employees will seek other opportunities, including starting new companies that will compete with you. Greater pay differences based on performance will lead to more turnover, but those quitting will generally be the lower-performing employees who will have more opportunities for greater pay at other firms that don't pay for performance.

4 Team-Based Rewards in Computer-Mediated Groups | By O. Rack, T. Ellwart, G. Hertel and U. Kondradt, published in *Journal of Managerial Psychology*, 2011

This study looked at how team-based rewards affect the performance, motivation and pay satisfaction of virtual team members, as well as communication within the team. Specifically, the study looked at the differences in these outcomes when using no rewards, equal rewards for each team member (equality), or rewards based on contribution to the team (equity). Finally, the study looked at how individual differences affect these relationships.

Findings | Both equity and equality-based rewards lead to better performance (but only for assertive team members), greater motivation, higher pay satisfaction and more communication among team members than the no-bonus condition. Also, team members receiving equal rewards were, on average, more satisfied with their pay than team members who received rewards based on their contribution to team performance.

The Bottom Line | Team-based bonuses have many positive effects, such as motivating, increasing pay satisfaction and increasing team communication. The greatest downside is the cost. When providing team bonuses, differences among the team members (based on performance) tends to lower overall pay satisfaction, but this is likely to be most noticeable in the poorer performers. Thus, the value of recognizing the best performers needs to be weighed with the value of better attitudes of the team as a whole. ws

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