# Compensation Management

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## Abstract

Compensation management is a key activity for supporting workforce performance and talent management processes. Today, the activities and systems that support compensation for executives, variable pay and rewards for those in sales, field service and contact centres, as well as stock and other incentive programs, are diverse and complex. It can be said that compensation is the "glue" that binds the employee and the employer together and in the organized sector, this is further modified in the form of a contract or a mutually binding legal document that spells out exactly how much should be paid to the employee and the components of the compensation package. Since, this paper is intended to be an introduction to compensation management, the art and science of arriving at the right compensation makes all the difference between a satisfied employee and a disgruntled employee.

**KEYWORDS:** Compensation management, rewards, organization, systems.

## Introduction

"If you pick the right people and give them the opportunity to spread their wings and put compensation and rewards as a carrier behind it - you almost don't have to manage them ".

**Jack Welch**

Compensation and Reward system plays vital role in a business organization. Since, among four Ms, i.e. Men, Material, Machine and Money, Men has been most important factor. Land, Labor, Capital and Organization are four major factors of production. Every factor contributes to the process of production/business. It expects return from the business process such as Rent is the return expected by the Landlord. Similarly Capitalist expects Interest and Organizers i.e. Entrepreneur expects profits .The labor expects wages from the process. It is evident that other factors are in-human factors and as such labor plays vital role in bringing about the process of production/business in motion. The other factors being human, has expectations, emotions, ambitions and egos. Labor therefore expects to have fair share in the business/production process. Worker's render their services for wages and salary, also called, compensation. In other words, workers exchange their work for compensation.

Wages and Salary have their impending bearings on employee performance and, in turn, organisational performance. Therefore, service rendered by workers to organisation has to be adequately paid. Various theories of wages have been propounded in the past to look into this issue. Yet, none have been able duly cover all aspects of the issue.

1) Why is the general wage level what it is?
2) What causes the wage structure to be what it is?

3) Why do these rates and structure vary widely between organisations and geographical regions?

Compensation is any form of payment given to the employees in exchange for the work they perform. Financial payment made at or near place where work is performed is called **"'Direct Compensation"** (e.g.: Wages, Salaries, Overtime Pay, and Commissions/Incentives and Bonuses). Compensation is a systematic approach to providing monetary value to employees in exchange for work performed. Compensation may achieve several purposes assisting in recruitment, job performance and job satisfaction.

**How is Compensation Used?**

Compensation is a tool used by management for a variety of purposes to further the existence of the company. Compensation may be adjusted according the business needs, goals and available resources. Compensation may be used to

- Recruit and retain qualified employees.
- Increase or maintain morale/satisfaction.
- Reward and encourage peak performance.
- Achieve internal and external equity.
- Reduce turnover and encourage company loyalty.
- Modify (through negotiations) practices of unions

**Essentials of the Compensation System**

A) Fairness or equity: The most important objective of any pay system is fairness or equity. Equity has three dimensions, namely:

- **Internal equity:** It ensures that more difficult jobs are paid more and jobs of similar nature and difficulty are paid equally.
- **External equity:** It ensures that jobs are fairly compensated in comparison to similar jobs in the industry and other rival companies.
- **Individual equity:** It ensures equal pay for equal work that is; each individual's pay is fair in comparison to others doing the same or similar jobs.

***(a)*** **Attract talents:** Compensation needs to be high enough to attract talented people. Since many firms compete to hire the services of competent people, the salaries offered must be high enough to motivate them and attract towards an organization.

***(b)*** **Retain talents:** If compensation levels fall below the expectations of the employees or are not competitive, employees may quit the organization in frustration. Hence many firms include compensation plans as an integral part of the employee retention plan of the organization.

***(c)*** **New and desired behavior:** Pay should reward loyalty, commitment, experience, risk taking, initiatives and other desired behaviors.

***(d)*** **Control costs:** The cost of hiring people should not be too high. Effective compensation management ensures that workers are neither overpaid nor underpaid.

***(e)*** **Comply with legal rules:** Compensation programs must invariably satisfy Government rules and regulations regarding minimum wages, bonus, allowances, benefits etc.

***(f)*** **Ease of Operation:** The compensation management system should be easy to understand and operate.

**COMPONENTS OF REMUNERATION**

Wages

Wages represent hourly rates of pay, and salary refers to the monthly rate of pay, irrespective of the number of hours put in by an employee. Wages and salaries are subject to annual increments. They differ from employee to employee, and also depend upon the nature of the job performed, seniority levels and merit of the individual. The wage structure in India can be broadly examined under the following heads:

*(a)* **Basic Wage:** The various awards by wage tribunals wage boards, pay commission reports and job evaluations also serves as guiding principles for determining the "Basic Wage". While deciding the Basic wage, the following criteria may be considered, namely: (i) Skills need of the Job (ii) Experience needed (iii) Difficulty of work-mental as well as physical (iv) Training needed (v) Responsibilities involved (vi) Hazardous nature of the Job.

*(b)* **Dearness Allowances (DA):** It is the allowance paid to the employees in order to enable them to face the increasing dearness of essential commodities. It serves as a cushion, a sort of insurance against the increase in price levels of commodities. Instead of increasing wages every time-there is a rise in price levels; DA is paid to neutralize the effects of inflation.

*(c)* **House Rent Allowance (HRA):** Housing is one of the most burning issues in metropolitan cities. Rising prices of residential premises and high rentals is a bane of big metropolitan cities. To attract and retain talent, employers offer to meet part of the rental costs of the employee in the form of House Rent Allowance (HRA).

*(d)* **Conveyance Allowance:** It includes any allowance granted to meet the cost of travel on tour or on transfer, any allowance, whether, granted on tour or for the period of journey in connection with transfer, to meet the ordinary daily charges incurred by an employee on account of absence from his normal place of duty; any allowance granted to meet the expenditure incurred on conveyance in performance of duties of an office or employment of profit.

*(e)* **Transport Allowance:** It is the allowance granted for commuting between place of residence and the place of duty.

**Factors affecting on compensation Management**

The wage policy of different organizations varies somewhat. Marginal units pay the minimum necessary to attract the required number and kind of labor. Often, these units pay only the minimum wage rates required by labor legislation, and recruit marginal labor. At the other extreme, some units pay well above the going rates in the labor market. They do so to attract and retain the highest calibers of the labor force. Some managers believe in the economy of higher wages. They feel that, by paying high wages, they would attract better workers who will produce more than the aver rage worker in industry.

A sound wage policy is to adopt a job evaluation programme in order to establish fair differentials in wages based upon differences in job contents. Besides the basic factors provided by a job description and job evaluation, those that are usually taken into consideration for compensation management are:

1) The organization’s ability to pay
2) Supply and demand of labor
3) The prevailing market rate

4) The cost of living
5) Living wage
6) Productivity
7) Trade union's Bargaining power
8) Job Requirements
9) Managerial Attitudes
10) Psychological and Sociological factors
11) Levels of skill available in the market

**(1) The Organization's Ability to Pay:** Wage increases should be given by those organizations which can afford them. Companies that have good sales and, therefore, high profits tend to pay higher wages than those which running at a loss or earning low profits because of the high cost of production or low sales. In the short run, the economic influence on the ability to pay is practically nil. All employers, irrespective of their profits or losses, must pay no less than their competitors and need pay no more if they wish to attract and keep workers. In the long run, the ability to pay is very important. During the time of prosperity, employers pay high wages to carry on profitable operations and because of their increased ability to pay. But during a period of depression, wages are cut because funds are not available. Marginal firms and non-profit organizations (like hospitals and educational institutions) pay-relatively low wages because of low or no profits.

**(2) Supply and Demand of Labor:** The labor market conditions or supply and demand forces operate at the national, regional and local levels, and determine organizational wage structure and level.

If the demand for certain skills is high and the supply is low. The result is a rise in the price to be paid for these skills. When prolonged and acute, these labor-market pressures probably force most organizations to "reclassify hard-to-fill jobs at a higher level" than that 'suggested by the job evaluation. The other alternative is to pay higher wages if the labor supply is scarce; and lower wages when it is excessive. Similarly, if there is great demand for labor expertise, wages rise; but if the demand for manpower skill is minimal, the wages will be relatively low.

(3) **Prevailing Market Rate:** This is also known as the 'comparable wage' or 'going wage rate', and is-the most widely used criterion. An organization's compensation policies generally tend to conform to the wage-rates payable by the industry and the community. This is done for several reasons. First, competition demands that competitors adhere to the same relative wage level. Second, various government laws and judicial decisions make the adoption of uniform wage rates an attractive proposition. Third, trade unions encourage this practice so that their members can have equal pay, equal work and geographical differences may be eliminated. Fourth, functionally related firms in the same industry require essentially the same quality of employees, with the same skills and experience. This results in a considerable uniformity in wage and salary rates. Finally, if the same or about the same general rates of wages are not paid to the employees as are paid by the organization's competitors, it will not be able to attract and maintain a sufficient quantity and quality of manpower.

(4) **The Cost of Living:** The cost-of-living pay criterion is usually regarded as an automatic minimum equity pay criterion. This criterion calls for pay adjustments based on increases or decreases in an acceptable cost of living index. In recognition of the influence of the cost of living, "escalator clauses" are written into labor contracts.

When the cost of living increases, workers and trade unions demand adjusted wages to offset the erosion of real wages. However, when living costs are stable or decline, the management does not resort to this argument as a reason for wage reductions.

(5) **The Living Wage**: criterion means that wages paid should be adequate to enable an employee to maintain himself and his family at a reasonable level of existence. However, employers do not generally favor using the concept of a living wage as a guide to wage determination because they prefer to base the wages of an employee on his contribution rather than on his need. Also, they feel that the level of living prescribed in a worker's budget is open to argument since it is-based on subjective opinion.

(6) **Productivity** is another criterion, and is measured in terms of output per man-hour. It is not due to labor efforts alone. Technological improvements, better organization and management, the development of better methods of production by labor and management, greater ingenuity and skill by labor are all responsible for the increase in productivity. Actually, productivity measures the contribution of all the resource factors — men, machines, methods, materials and management. No productivity index can be devised which will measure only the productivity of a specific factor of production. Another problem is that productivity can be measured at several levels — job, plant, industry or national, economic level. Thus, although theoretically it is a sound compensation criterion, operationally many problems and complications arise because of definitional measurement and conceptual issues.

(7) **Trade Union's Bargaining Power:** Trade unions do affect rate of wages. Generally, the stronger and more powerful the trade union, the higher the wages. A trade union's bargaining power is often measured in terms of its membership, its financial strength and the nature of its leadership. A strike or a threat of a strike is the most powerful weapon used by it. Sometimes trade unions force wages up faster than increases in productivity would allow and become responsible for unemployment or higher prices and inflation. However, for those remaining on the pay roll, a real gain is often achieved as a consequence of a trade union's stronger bargaining power.

(8) **Job Requirements:** Generally, the more difficult a job, the higher are the wages. Measures of job difficulty are frequently used when the relative value of one job to another in an organization is to be ascertained. Jobs are graded according to the relative skill, effort, responsibility, and job conditions required.

(9) **Managerial Attitudes:** These have a decisive influence on the wage structure and wage level since judgment is exercised in many areas of wage and salary administration — including whether the firm should pay below average, or above average rates, what job factors should be used to reflect job worth, the weight to be given for performance or length of service, and so forth, both the structure and level of wages are bound to be affected accordingly. These matters require the approval of the top executives. Lester observes "Top management's desire to maintain or enhance the company's prestige has been a major factor in the wage policy of a number of firms. Desires to improve or maintain morale, to attract high-caliber employees, to reduce turnover, and to provide a high living standard for employees as possible also appear to be factors in management's wage-policy decisions.

(10) **Psychological and Social Factors:** These determine in a significant measure how hard a person will work for the compensation received or what pressures he will exert to get his compensation increased. Psychologically, persons perceive the level of wages as a measure of success in life; people may feel secure; have an inferiority complex, seem inadequate or feel the reverse of all these. They may not take pride in

their work, or in the wages they get. Therefore, these things should not be overlooked by the management in establishing wage rates. Sociologically and ethically, people feel that "equal work should carry equal wages" that" wages should be commensurate with their efforts, "that" they are not exploited, and that no distinction is made on the basis of caste, color, sex or religion." To satisfy the conditions of equity, fairness and justice, a management should take these factors into consideration.

**(11) Skill Levels Available in the Market: -** with the rapid growth of industries, business trade, there is shortage of skilled resources. The technological development, automation has been affecting the skill levels at faster rates. Thus the wage levels of skilled employees are constantly changing and an organization has to keep its level up to suit the market needs.

## Conclusion

To survive and be successful in a global economy, an organization must be competitive. A major factor underlying organizational competitiveness is labor cost. Not only must an organization pay its workforce a competitive wage within its geographic region, but also it must vary their and amounts of rewards offered, recognizing differences in individual contributions. A major difference in individual contributions relates to the knowledge and skills the employee brings to the workplace and the interest, effort and innovative qualities the employee provides in completing work assignments. The pay and rewards system of the organization must stimulate acceptable levels of performance from all employee. Compensation management plays an important role in assisting management to achieve competitive costs. A sound wage programme can also assure management of the ability to hire and retain a competent workforce. In the changing world of automation and job complexities, this can be a great asset toward achieving overall company goals.

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