

# Compensation Management

SECOND EDITION

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# Introduction to Compensation Management

## Learning Objectives

After reading this chapter, you will be able to

- understand the term compensation from different perspectives
- analyse difference between wages and compensation
- study various principles of compensation/wage fixation
- examine theories of wage determination
- comprehend the basic dynamics of wage policy and objectives
- understand the various domains of compensation
- understand the concept of cost to company
- comprehend the terms pay grades and pay bands



## Compensation Redesign at DeriPharma

Motivating and retaining good performers is an important priority for any organization. Companies cannot retain talent with high salaries alone. They also need to develop compensation packages that address the real and perceived needs of employees. It may include, among other things, making provisions for short- and long-term incentives, stock options, assistance in achieving financial goals, favourable tax incentives, and assistance with lifestyle requirements of employees. This requires strategic compensation design. Recently, DeriPharma, a global pharmaceutical major, noticed that its executives were leaving to join relatively lesser-known competitors. The company had always believed in stability and long-term incentives, focusing on secure post-retirement lives for all its employees. According to the company, the majority of executives leaving their jobs were in their mid-thirties. The average age of employees is 55, so the executives in their mid-thirties

Base	
HRA	
EPF	
Gratuity	
Variable	
Bonus	
LTA	
Conveyance	
Medical	

were the future torchbearers. An investigative study indicated that most of the employees left because of compensation issues. It was recommended that the compensation package be redesigned to increase the take-home pay and discount the deferred benefits<sup>1</sup> for this age group. This resulted in increased retention of employees.

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## INTRODUCTION

The term compensation as a substitute for wages or salaries is of recent origin. The literature on wages and salaries is enormous, but most of it approaches the subject from a legal perspective. The emphasis is on ensuring that the legal requirements for wages set by government are met. However, increased competition and specialized nature of jobs have transformed the job market from a seller's market to a buyer's market. Wages have now become very significant as a cost factor. Therefore, strategic management of wages has now become very important for organizations. With this shift in approach and focus, compensation has come to be viewed as the strategic management of wages and salaries. In India, literature on compensation is scarce. However, it has now become imperative for organizations to balance the cost of compensation and employee motivation to survive in a competitive world.

Pay or compensation represents an exchange between the employee and the organization. Each gives something in return for something else. What the employee provides the employer is a labour service, usually known as work. This labour service consists of many different kinds of employee behaviour such as showing up regularly and on time, carrying out tasks dependably, cooperating with others, and making useful suggestions. In the past, the compensation issue was often confidential and governed by the individual employer's preference and choices. However, in today's competitive world, compensation issues are more transparent and every employee can make an informed choice based on information available about compensation packages. Therefore, balancing the cost of compensation and retaining employees has now become the most important priority for today's organizations.

Different scholars in different countries have defined the word compensation from different perspectives. Before, we develop our own definition of the term compensation; let us briefly look at some of these perspectives. Globally, almost every country views compensation as a measure of justice. In addition, some countries (particularly the developed ones) consider compensation as a means of protection against potential job loss. Therefore, compensation should be fair, irrespective of economic considerations. Many scholars believe

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<sup>1</sup>Deferred benefits are payable only after qualifying service or retirement. New-generation employees prefer take-home pay over deferred benefits.

that compensation is the outcome of productivity. The literal meaning of the term compensation is something that counterbalances the efforts of workers. In China, it was represented by the symbols for logs and water, that is, something which ensures the basic necessities of life. In Japan, it is viewed as providing something. In India, right from the Vedic age, the volume of work and the time required to perform the work were considered to decide compensation. In Europe, the church advocated the principles of just wage or compensation. Without further exploring the historical connotations of the term compensation and instead considering the modern organization, the word compensation may be defined as, 'all forms of financial returns, tangible services, and benefits that an employee receives in his/her tenure of employment'. It is viewed as a system of rewards to motivate employees, so that organizations can achieve their intended goals and objectives. The modern definition of compensation, however, considers both intrinsic (psychological) and extrinsic (tangible) components of compensation. While extrinsic compensation covers both monetary and non-monetary rewards, intrinsic compensation reflects the employees' mental satisfaction with their job accomplishments.

## Wages and Compensation

A wage is a basic compensation for labour; and the compensation for labour per period of time is referred to as the wage rate. The two terms are sometimes used interchangeably. Other frequently used terms for wages are payment per unit of time (typically an hour) or earnings, which represent payment accrued over a time period (week, month, or year). Total compensation represents earnings and other benefits for labour. Wage income represents total compensation and unearned income. Wages are also referred to as economic rent, which is total compensation minus the opportunity cost. Opportunity cost represents cost of something in terms of an opportunity forgone (and the benefits which could have been received if that opportunity was utilized), or the most valuable forgone alternative (or highest-valued option forgone), that is, the cost of choosing the second best alternative. Etymologically, the term wage is derived from words that indicate making a promise in monetary form. The term emerged from the French word *wagier* or *gagier*, meaning to pledge or to make a promise.

Marxian economics suggests that the payment of wages to workers should be based on the optimal allocation of cooperative human labour. Optimization, here, does not indicate only a technical variable, because workers are not considered just a factor of production. Rather, workers' participation in the production process can be oppressive, irrational, and exploitative; it can also be beneficial, rational, or effective. Marxian economics believes that wages have a political dimension as the interests of workers and employers are different. Therefore, it believes that the most desirable form of labour organization in the workplace is one where workers manage themselves collectively and elect managers where necessary.

From a financial perspective, wage, in contrast with salary, is defined as cash paid for some specified quantity of labour. Wages are paid based on the wage rate (based on units of time), whereas salaries are paid periodically without reference to a specified number of hours worked. Given an established job description, wages can often be negotiated by workers through collective bargaining.

Economists define wages more broadly than just cash compensation and include any return on labour such as goods workers might create for themselves, returns in kind, or even the enjoyment that some derive from work. Even food hunted or gathered is considered wages and any return resulting from an investment in tools (e.g., an axe or a hoe) is deemed interest (a return on a capital investment).

### ***Differences between wages and compensation***

For a better understanding of the difference between wages and compensation, let us consider the International Labour Organization's (ILO) series of texts on labour costs.

The term labour cost is best understood from the definitions accepted in ILO's Eleventh International Conference of Labour Statisticians (Geneva 1966). Labour cost is the cost incurred by the employer in the employment of labour. The statistical concept of labour cost comprises remuneration for work performed. This also includes payments in respect of time paid for but not worked; bonuses and gratuities; the cost of food, drink, and other payments in kind; the cost of workers' housing borne by employers; employers' social security expenditures; the cost to the employer for vocational training, welfare services; and miscellaneous items such as the transport of workers, work clothes, and cost of recruitment, and taxes paid by the employers on employment. From the employers' perspective, therefore, the compensation of employees consists of all payments (in kind or in cash), and all contributions to employees' social security, pension, insurance, etc.

Labour cost and the compensation of employees are closely-related concepts with many common elements. The major part of labour cost comprises compensation of employees. However, definitions of labour cost and the compensation of employees differ from country to country. For example, some items of labour cost such as social security and vocational training are borne not by employers but by the respective governments. In India, the Central Board for Workers' Training and the Regional Labour Institutes provide either free or subsidized training for industrial workers. Similarly, the Regional Provident Fund Commission now marginally contributes to employees' pension along with the employers. The state's contributions to wage-related social security schemes are not included in the cost of compensation for employers. In some countries, payroll taxes or employment taxes are considered labour costs.

Operationally, there is no difference between the terms compensation and wages. Both are intended to price the efforts of employees. However, the word

compensation is used more holistically to acknowledge the strategic importance of wages. Theoretically, compensation means something such as money given or received as payment for some damage. However, in human resource management literature, we consider the term from a broader perspective, that is, the strategic use of wages paid to employees. Some organizations prefer to use the term rewards instead of wages or compensation. In human resource management, we should not just use rewards to acknowledge good performances, instead, as a more strategic design of compensation. So that, when employees get paid at the end of the month, they feel they are not just getting their wages, but also being rewarded. In this chapter, however, the terms compensation, wages, and salary have been used interchangeably.

Compensation or wage structure in a given case should take into account industrial adjudication as well as considerations of right and wrong, and fairness and unfairness. Given social conscience and the welfare policy of the state, collective bargaining is now considered the most dynamic form of negotiation to decide wage structure in a particular organization. Wage issues are no longer purely mathematical issues. It was with this perspective that the framers of the Constitution drew up Article 43 (part of the Directive Principles of State Policy) which states that, 'The state shall endeavour to secure, by suitable legislation or economic organization or in any other way, to all workers—agriculture, industrial, or otherwise—work, a living wage, conditions of work ensuring a decent standard of life and full employment of leisure and social and cultural opportunities.' By this declaration, the state not only acknowledged its role in directly promoting social welfare, but also recognized the inadequacy of market forces in determining a wage level that is consistent with welfare standard of a living wage. The declaration, in effect, assured labour that where they were not able to secure a living wage for themselves, the government through legislation or other means will come to their aid. Two aspects of the state's role prevent employers from taking undue advantage of the workers'—strong bargaining strength and direct participation of the state in the economic life of the nation. The former gives the worker a fair share, and the latter enlarges this share.

## **Wage Components**

Wage or compensation is any economic compensation paid by the employer to an employee for the services he renders. Although the term wages is all encompassing and includes any form of financial support and benefits, in a narrower sense wages are the price paid for the services of labour. Broadly, there are two wage components—the base or basic wages and other allowances. The basic wage is the remuneration by way of basic salary and allowances, that is, paid or payable to an employee per terms of the contract of employment for the work done. Allowances are paid in addition to the basic wage to ensure that the value of basic wages does not fall over a period of time. Some allowances are statutory,



whereas others are voluntary. Most organizations pay allowances such as holiday pay, overtime pay, bonus, and social security benefits. Theoretically, these are not included in the definition of wages. In India, different Acts include different items under wages, though all the Acts include basic wage and dearness allowances. Under the Workmen's Compensation Act 1923 Section 2 (m), wages includes, 'Wages for leave period, holiday pay, overtime pay, bonus, attendance bonus, and good conduct bonus.' Under The Payment of Wages Act 1936 Section 2 (VI), 'Any award of settlement and production bonus, if paid, constitutes wages.' Further, under the Payment of Wages Act 1948, 'Retrenchment compensation, payment in lieu of notice and gratuity payable on discharge constitute wages.'

Without going into the theoretical debate on what constitutes wages and to summing up the provisions of different Acts, we can exclude the following types of remuneration from the purview of wages:

1. bonus or other payments under a profit-sharing scheme, which do not form a part of the contract of employment
2. value of any house or accommodation, supply of light, water, medical attendance, travelling allowance or payment in lieu thereof, or any other concession
3. any sum paid to defray special expenses entailed by the nature of the employment of a workman
4. any contribution to pension, provident fund, or a scheme of social security, and social insurance benefits
5. any other amenity or service excluded from the computation of wages by a general or special order of an appropriate governmental authority

A wage level is an average of the rates paid for the jobs of an organization, an establishment, a labour market, an industry, a region, or a nation. A wage structure is a hierarchy of jobs to which wage rates have been attached.

## OBJECTIVES OF COMPENSATION

The objectives of compensation or wages can be classified under four broad categories—equity, efficiency, macro-economic stability, and optimum allocation of labour.

### **Equity**

The first category is equity, which may take several forms. It includes income distribution through narrowing of inequalities, increasing the wages of the lowest paid employees, protecting real wages (purchasing power), and the concept of equal pay for work of equal value. Compensation management strives for internal and external equity. Internal equity requires that pay be related to the relative worth of a job so that similar jobs get similar pay. External equity means paying workers what other firms in the labour market pay comparable workers.

Compensation differentials, based on differences in skills or contribution, are all related to the concept of equity.

### **Efficiency**

It is often closely related to equity, because the two concepts are not antithetical. The objectives of efficiency are reflected in attempts to link a part of wages to productivity or profit, group or individual performance, acquisition and application of skills, and so on. Arrangements to achieve efficiency may also be seen as being equitable (if they fairly reward performance) or inequitable (if the reward is viewed as unfair).

### **Macroeconomic stability**

It can be achieved through high employment levels, and low inflation. For instance, an inordinately high minimum wage would have an adverse impact on levels of employment. Though the level at which it would occur is a matter of debate.

Although compensation and compensation policies are two of the many factors that influence macroeconomic stability, they do contribute to (or impede) balanced and sustainable economic development.

### **Efficient allocation of labour**

The efficient allocation of labour in the labour market implies that employees will move to wherever they receive a net gain. Such movement may be from one geographical location to another, or from one job to another (within or outside an enterprise). The provision or availability of financial incentives causes such movement.

For example, workers may move from a labour surplus or low-wage area to a high-wage area. They may acquire new skills to benefit from the higher wages paid for skills. When an employer's wages are below market rates, employee turnover increases. When it is above market rates, the employer attracts job applicants. When employees move from declining to growth industries, an efficient allocation of labour due to structural changes takes place.

## **Other Objectives of Compensation**

Apart from those listed common objectives, from human resource management perspective, a well-designed compensation package helps an organization to achieve additional objectives.

**Acquire qualified personnel** Compensation needs to be high enough to attract qualified applicants. Pay levels must respond to the supply and demand of workers in the labour market since employers compete for workers. Premium wages are sometimes needed to attract qualified applicants already working for others.

**Retain current employees** Employees may quit when compensation levels are not competitive, resulting in higher turnover.

**Reward desired behaviour** Pay should reinforce desired behaviours and act as an incentive for such behaviour to occur in the future. Effective compensation plans reward performance, loyalty, experience, responsibility, and other behaviours.

**Control costs** A rational compensation system helps the organization obtain and retain workers at a reasonable cost. Without effective compensation management, workers might be over-paid or under-paid.

**Comply with legal regulations** A sound wage and salary system considers the legal challenges imposed by the government and ensures the employer's compliance.

**Facilitate understanding** The compensation management system should be easily understood by human resource specialists, operating managers, and employees.

**Promoting administrative efficiency** Wage and salary programmes should be so designed that they can be managed efficiently, making optimal use of the human resource information systems (HRIS). However, this objective should be a secondary consideration compared with other objectives.

## Payroll and Compensation

Payroll is an administrative function that integrates the functions of compensation management, or human resource management function, with accounting function of an organization. Payroll ensures employees of an organization regularly receive their paychecks, along with a statement, showing details of the net pay received by them. Depending on the size of the organization, there may be dedicated payroll manager to manage the payroll functions. However, in most of the cases, payroll management is left to the human resource management function. Payroll is often confused with compensation. However, these two are different operationally. Scope of payroll is limited to disbursement function of compensation, that is, it involves payment of regular salary and wages, and other monetary aspects of compensation such as bonus, commissions, and allowances. In one way, we can define payroll as detailed accounting of compensation, deductions from compensation—provident fund, service tax, income tax—and payment to employees at regular monthly cycle. Although, it is a part of compensation management function, in many organizations, payroll worksheets are prepared by the Accounts Division, based on the payroll data of human resource management department. Payroll preparation is now possible with standard payroll software. Some companies outsource the payroll function to achieve cost efficiency.

Compensation, therefore, is distinctly different from payroll, as it is more holistic in terms of all benefits and perquisites in addition to the regular wages and salaries of employees.

## Compensation and Talent Management

Talent is rare and inimitable human resource value, for which organizations compete globally. A talent driven organizations can outperform their competitors (Barney and Wright 1998). Business dynamics, today, has changed the business landscape of the world. To sustain in this business environment, organizations globally compete for talent. It requires organizations to suitably craft their talent strategy to attract and retain talented people, and also to develop internal talent pipeline. Over the years, mobility of talented people, across organizations, has increased manifold. Cross-border hiring, cross-industry hiring, and even talent poaching, have now almost become a regular pursuit for organizations. Global companies such as CISCO, Apple, Microsoft, Yahoo, and Google often acquire companies just to get talented people in their payroll, rather than focusing on increasing their value chain of product portfolio through acquisition. For talent, organizations focus on strategic human resource management practices. First among such strategies is employer branding. Successful employer branding, creates a positive image of the employer in the minds of the people, and as a natural process attracts the potential talent for the organization. Therefore, employer branding is the result of proactive human resource management practice, which includes among other, compensating employees based on talent.

Talent is a people value, which contributes to the success of any organization. A talented person, through innovation, enhances the competitive strength of an organization. Competency-based human resource management practices, of late, have institutionalized talent management in organizations. Talent is now the key driver of organizational success and sustenance. A talent driven organization focuses on building the future leadership pipeline through various human resource development (HRD), and organizational development (OD) initiatives. However, institutionalized talent management practices, among others, require organizations to align their compensation policies and plans. Hence, in crafting talent management strategy, organizations, now, also emphasize on integration of their compensation policies and strategies. This ensures attraction and retention of talent, incubating talent, and ultimately making the organization talent driven. It is for this, we need to understand compensation management issues that encompass effective talent management in an organization. Determining compensation for integrated talent management encompasses job evaluation, market surveys for external benchmarking data, competencies, work measurement, identification of organizational key performance indicators (KPI) and corresponding key performance areas (KPA) of employees, internal benchmarking to assess internal equity, etc. All these, when considered, can ensure compensation design to attract and retain talent, and cascade to effective talent management. All these processes have been discussed in subsequent chapters. Here, however, we are more concerned about

discussing compensation strategies and policy decisions that promote effective talent management in organizations.

Merit-based pay, performance related pay, innovative stock options, broad-based rewards and incentive plans, and provisions for deferred benefits and perquisites are all monetary compensation components used for effective talent management in organizations. Apart from these, organizations also make use of suitable non-monetary compensation components such as investing on learning and development opportunities, and vacation plans.

Some practices recommended for integrated talent management are listed below.

**Incentivize and motivate high performing workers** This can ensure attraction, development, and retention of talent in the organization. Some innovative incentivization policies are; performance based incentive plans, incentivization based on merit, decision on incentive-mix both monetary and non-monetary, etc. Incentives must be tuned with the expectations of employees. For this reason, many organizations adopt flexible reward policies which enable them to respond to the inputs received from talented employees. However, organizations must ensure that the overall spread of compensation is well within the policy limits.

**Designing compensation to drive business results** Compensation aimed at motivating and retaining talent may also create inequity in the organization. As long as such inequitable compensation outweighs revenue and profit growth of the organization, it can be sustained for talented employees. However, organizations may be required to consider the possible deteriorating effect on motivation and performance levels of other employees. It is for this reason; more emphasis is given on variables, contingent upon performance. This compensation strategy creates a sense of fair play by keeping the door of opportunity for greater compensation, open for all employees, whereas at the same time rewarding talented employees. This will not impair the overall compensation plan for the companies. While deciding on standard compensation, companies base their calculation on a number of factors, primary of which are their strategic and business goals, job roles, market data, internal pay ranges, and performance data for KPIs such as achievement of goal, performance ratings, and non-quantitative measures. Non-quantitative measures assess outcome of employees' performance, that is, the effect that the employees leave behind in achieving their performance results.

## Factors influencing Compensation

There are a number of factors which influence the compensation design in any organization. In generic terms, such factors may be; productivity or performance trend of employees, organizational ability to pay, government regulations, collective bargaining powers of trade unions, cost of living, labour market trends,

prevailing market rate, compensation philosophy of the organization, organizational culture, organizational strategies, organizational structure, etc. However, depending on the specific business goals and strategies, organizations assign different weight to different factors, while deciding on compensation.

However, based on the organizational compensation management practices, such factors can be classified, broadly, into two categories; internal factors and external factors. Internal factors are organization specific, whereas external factors are those which are outside the organization. Organizations respond to these factors to remain competitive in compensation they offer to their employees. Time to time calibration with internal and external factors helps organizations to remain competitive by acquiring and retaining talent, motivating employees, and by institutionalizing a performance-driven work culture.

To enhance our understanding of compensation design, let us now elaborate on such internal and external factors that influence it.

### **Internal factors**

Internal factors being specific to the organization may widely vary even between two similar or peer group organizations. Further, some internal factors are attributable to organizations as a whole, whereas some others are specific to employees of the organization.

Internal factors attributable to organizations are as follows:

**Ability to pay** At organizational level, ability to pay is the most important determinant of compensation. Often organizations, despite their good intentions fail to pay competitive compensation to their employees, due to their financial handicap. Successive business failure challenges the sustainability of the organization, forcing them even to reduce the existing compensation level. Such organizations face the challenge of talent retention. In contrast, a financially viable organization can pay competitive compensation to their employees. Such organizations even at times pay more than their peer group companies. For example, Microsoft and Apple benchmark their executive compensation not only with their peer group companies, but also with other best paying world class organizations to attract and retain talent.

**Organizational strategy** Compensation programme of an organization is also influenced by their strategy and business goals. For accelerated pace of growth, some organizations (even in some cases, start-ups) offer higher compensation. Contrarily for stable growth, organizations may stick to reasonable compensation level, with more focus on fixed component. In the first case, organizations may deliberately encourage internal inequity so that average and poor performers become more productive to catch up with the compensation level of their peers. In the second case, organizations value more internal pay equity. For example, century old Murugappa Group values internal pay equity, while designing their compensation programmes; and surprisingly they are able to retain their talents and grow over the years.

Internal factors attributable to employees are as follows:

**Competency level** When employees' competency level matches with the organization's required competency level for the specific job positions, compensation would be higher. Contrarily, it would be less.

**Performance of employees** Performance related pay (PRP) is increasingly practised in compensation management across the world. Many Indian organizations, including public sector enterprises have already started using it as major determinant of compensation programme. Employees get more compensation when they meet and exceed the expected level of performance, and in the reverse case, they get less.

**Seniority and job experience** With experience and seniority, employees are expected to perform better due to their increased understanding of the job. Such employees are valued by the organization.

**Employee potentiality** For effective succession planning, firms assess the potentiality of their employees. Once they identify the potential employees for future leadership positions, differentiation in the compensation levels can be made by offering these employees higher pay.

**Compensable factors for the job** Through job evaluation, firms determine the compensable factors for a job. Jobs with higher compensable factors get higher compensation, whereas jobs with lower compensable factors get less compensation.

### **External factors**

External factors have potential influence on the compensation design even though they are exogenous to an organization. Such factors are as follows:

**Legal mandates** Almost in all countries, including India, legal mandates influence the compensation design. For example, in India we have Minimum Wages Act, Factories Act, Payment of Wages Act, Payment of Bonus Act, Industrial Disputes Act, Equal Remuneration Act, etc. which have major influence on compensation design.

**Labour market trends** Labour market trends are not only limited to demand and supply of labour, it also encompass various other issues such as compensation trend, cost of living, and other organizational practices. All these have potential effect on compensation design.

**Economic state of the country** Economic ups and downs may have potential effect on compensation.

**Inflation rate** Fluctuation in the rate of inflation may affect the compensation levels.

**Technological changes** Technological changes bring compositional shift in skill requirements, resulting in increased pay for employees who acquire such skills.

All these internal and external factors have potential influence on compensation design of an organization.

## PRINCIPLES OF COMPENSATION FORMULATION

The main factors affecting wage or compensation levels within an organization are external relativities, salary, and individual worth.

**External relativities** Market rates as affected by supply, demand, and general movements in pay levels.

**Salary** Salary relativities between jobs within the organization depending on the values attached to different jobs.

**Individual worth** The value of the individual's performance to the organization.

### Determinants of Wage Rates

Depending on the structure and traditions of different economies around the world, wage rates are either the product of market forces (supply and demand), or they may be influenced by other factors such as tradition, social structure, and seniority. In the United States, market forces determine wage rates. In Japan, seniority is still the dominant factor for wage determination. Several countries, including India, have enacted a statutory minimum wage rate that fixes the price of certain kinds of labour. Though market forces determine the wage rate in most developed countries, workers often negotiate their wage rate through collective bargaining wherever unions are present.

Often, we use the term benefit to indicate wages. Theoretically, benefit refers to something which someone is entitled to receive. Workers' benefit component is the non-monetary part of the compensation.

Organizations often confuse unearned income with wages. Theoretically, unearned income includes interest, dividends, or realized capital gains from investments, rent from land, or property ownership, as well as any other income that is not derived from work. It means that even the interest earned on the provident funds of workers (in cases where the employers themselves are the trustee) cannot be construed as wages. Some parts of the unearned income are taxable, where as some other parts are not (e.g., interest on provident fund). Economists, however, have a differing point of view, as they consider unearned income as compensation for deferring consumption.

*Economic rent* is the difference between what a factor of production is paid and how much it would need to be paid to remain in its current use. There are multiple mechanisms that can create economic rent—political contrivance, network effect, monopoly power, etc. Neoclassical economists consider economic rent as the difference between the incomes from a factor of production in a particular use. However, this definition does not tell us whether the income is earned by virtue of a contribution to society, or simply created by natural occurrence or government sanction. Therefore, they are considered an unearned privilege.

The consideration of *opportunity costs* is one of the key differences between the concepts of economic cost and accounting cost. Assessing opportunity



costs is fundamental to assessing the true cost of any course of action. In a case where there is no explicit accounting or monetary cost (price) attached to a course of action, ignoring opportunity costs may produce the illusion that its benefits cost nothing at all. The unseen opportunity costs then become the implicit hidden costs of that course of action.

## THEORIES OF WAGE DETERMINATION

There are two key theories to determine wages—the traditional theory of wage determination and the theory of negotiated wages.

### Traditional Theory of Wage Determination

Like all other factors of production, price of labour, that is, wages also depends on demand and supply of labour. This idea of classical economists is still found valid in wage determination, particularly in an open economy. In the United States, an electrician's job, due to higher demand, attract more wages than the wages of a manager of a retail store. This interplay between the demand and supply of labour depends on a number of factors such as availability of specific skill set, job location, and availability of jobs. When demand exceeds supply of workers, the wage rate rises; in the reverse case, the wage rate falls. At the intersection of supply and demand curve of workers, we get the equilibrium wage rate. However, this requires reaching the level of perfect competition, which for labour market, is elusive.

### Theory of Negotiated Wages

Unionized employees can negotiate salaries. This is done through the *collective bargaining* process. Normally, in any unionized organization, unions periodically submit their memorandum to the management, asking for wage raises to keep pace with market standards and organizational profitability. Then, wages are negotiated in a collective bargaining meeting attended by the unions and the management nominees. For non-unionized employees, wages can be negotiated through *individual bargaining*. In some cases, there may even be regulatory intervention by wage boards. The wage boards are tripartite in nature and represent the workers, employers, and independent members. Wage boards help in finalizing wage recommendations. All wage boards, however, are not statutory. Wage boards are now less important because of the rising bargaining power of workers and employees.

### Principles of Compensation Determination

Wage determination, apart from the statutory aspect, is influenced by different theories. These theories are elaborated in this section.

**Subsistence theory** David Ricardo (1772–1832) advocated the subsistence theory. In Ricardo's words, workers should be paid 'To enable them to subsist and perpetuate the race without increase or diminution'. The theory was based on the assumption that if the workers were paid more than subsistence wage, their numbers would increase as they would procreate more and this would bring down the rate of wages. If the wages fell below the subsistence level, the number of workers would decrease as many would die of hunger, malnutrition, disease, cold, etc. and many would not marry. If this happened, wages would increase. In economics, the subsistence theory of wages states that, in the long run, wages will be reduced to the minimum level needed to keep workers alive.

**Wages fund theory** This theory was developed by Adam Smith (1723–1790) on the assumption that wages are paid out of a predetermined fund of wealth, the surplus savings of the wealthy. This fund could be utilized for employing labourers for work. If the fund was large, wages would be high; if it was small, wages would be reduced to subsistence level. The demand for labour and the level of wages were determined by the size of the fund.

**Surplus value theory** The surplus value theory of wages owes its development to Karl Marx (1818–1883). According to this theory, labour is an article of commerce, which could be purchased on the payment of the 'subsistence price'. The price of any product is determined by the labour and the time needed for producing it. The theory proposes that labourer is not paid in proportion to the time spent on work, but is paid much less and the surplus is utilized for paying other expenses.

**Residual claimant theory** The residual claimant theory advocated by Francis Walker (1840–1897), assumes that there are four factors of production/business activity—land, labour, capital, and entrepreneurship. Wages represent the amount of value created in the production, which remains after payment has been made for all these factors of production. In other words, labour is the residual claimant.

**Marginal productivity theory** This theory assumes that wages are based upon an entrepreneur's estimate of the value that will probably be produced by the last or marginal worker. In other words, it assumes that wages depend upon the demand for and supply of labour. Consequently, workers are paid what they are economically worth.

**Bargaining theory of wages** This theory considers that wages are determined by the relative bargaining power of workers, trade unions, and employers. When a trade union is involved, basic wages, fringe benefits, job differentials, and individual differences tend to be determined by the relative strength of the organization and the trade union.

**Behavioural theory of wages** This theory was pioneered by several psychologists and sociologists such as Marsh and Simon, Robert Dubin, and Eliot Jacques. Based on their various research studies, we can identify the following areas of interest in behavioural theories on wages:

**Employee's acceptance of a wage level** Individuals believe in employment stability and prefer to stay on with the same organization, pacing with their salary level. There are, however, several other factors to be considered such as size and prestige of the company; trade unions' power in the organization; and their level of knowledge and competencies.

**Internal wage structure** Employees value internal pay equity. Moreover, some jobs also command social status (e.g., the job of a journalist). Organizations design wages for different cross sections of employees by also considering maximum and minimum wage differentials, norms of span or control, and demand for specialized skill sets. Balancing of wages with such internal equity enhances employee motivation.

## TYPES OF WAGES

In this section, we have discussed various types of wages in India.

### Minimum Rate of Wages

The minimum rate payable to a worker and basic terms of his work are prescribed in the Minimum Wages Act 1948. The Act not only defines what would constitute minimum wages, but also provides a base for different aspects of terms of employment. Following are the key features of the Act and what they prescribe for different aspects like wages and term of work.

The Act provides multiple ways to interpret minimum wages. Any minimum rate of wages fixed or revised may consist of a basic rate of wages and a special allowance; or, a basic rate of wages with or without a cost of living allowance, and the cash value of concessions in respect of supplies of essential commodities at concessional rates. It is also interpreted as an all-inclusive rate allowing for the basic rate, the cost of living allowance, and the cash value of concessions, if any.

**Procedure for fixing and revising minimum wages** The Central Government appoints a Central Advisory Board to advise the central and state governments on the fixing and revising of the minimum rates of wages, as well as to coordinate the work of advisory boards.

The Central Advisory Board consists of persons nominated by the Central Government representing employers and employees in the scheduled employments in equal number, and independent persons not exceeding one-third of its total number of members. One such independent person is appointed the Chairman of the Board by the Central Government.

**Wages in kind** Minimum wages payable under this Act are to be paid in cash. However, the payment of minimum wages can be made wholly or partly in kind, by a notification in the official Gazette, where it is customary to pay wages either wholly or partly in kind.

**Payment of minimum rate of wages** The employer is required to pay every employee wages at a rate not less than the minimum rate of wages notified for that class of employees. There cannot be any deduction except as may be authorized.

**Fixing hours for a normal working day** In regard to any scheduled employment, minimum rates of wages in respect of which have been fixed under this Act

1. the appropriate government may fix the number of hours of work which shall constitute a normal working day, inclusive of one or more specified intervals;
2. provide for a day of rest in every period of seven days which shall be allowed to all employees or to any specified class of employees and for the payment of remuneration in respect of such days of rest;
3. provide for payment for work on a day of rest at a rate not less than the overtime rate.

**Overtime** If any employee whose minimum rate of wages is fixed under the Act works on any day in excess of the number of hours constituting a normal working day, the employer is required to pay him/her for excess hours at the overtime rate fixed under this Act or under any law of the appropriate government for the time being in force, whichever is higher.

**Wages for two or more classes of work** If an employee does two or more classes of work, to each of which a different rate of wages is applicable, the employer is required to pay to such employee in respect of the time respectively occupied in each such class of work, wages at not less than the minimum rate in force in respect of each such class.

**Maintenance of registers and records** Every employer is required to maintain registers and records giving particulars of employees, the work performed by them, the wages paid to them, the receipts given by them, and any other required particulars.

**Inspections** The appropriate government may, by notification in the official Gazette, appoint inspectors for the purpose of this Act and define the local limits for their functions.

**Claims** The appropriate government may, by notification in the official Gazette, appoint the Labour Commissioner or Commissioner for Workmen's Compensation or any officer not below the rank of Labour Commissioner or any other officer with experience as a judge of a civil court or as a Stipendiary Magistrate, to hear and decide for any specified area, all claims arising out of the payment of less than the minimum rates of wages as well as payment for days of rest or for work done.

**Penalties for offences** Any employer who contravenes any provision of this Act shall be punishable with imprisonment for a term, which may extend to six months or with fine, which may extend to ₹500 or with both.

**Statistics collected under the Minimum Wages Act 1948** All establishments covered under the Act are required to furnish to the concerned authority (Central or State) an annual return in prescribed form as per the rules framed under the Minimum Wages Act 1948. The centre/state governments in turn send a consolidated return to the Labour Bureau which compiles an all India report based on the data contained in these returns. Besides, quarterly returns sent by these agencies to the Bureau are also made use of in compiling information at all India level.

**Addition of new employments** The state governments and the union territories review the scheduled employments under their jurisdiction from time to time and add new employments in respect of which they are of the opinion that minimum rates of wages should be fixed statutorily in addition to the existing ones.

### Need-based Minimum Wage

From normative perspectives, the Committee on Fair Wages indicated that the minimum wages provide 'not merely for the bare sustenance of life, but for the preservation of the efficiency of the worker by providing for some measure of education, medical requirements, and amenities'. This recommendation was further stretched to develop the concept of need-based minimum wages by the Indian Labour Conference (1957).

For the calculation of the minimum wage, the Conference accepted the following norms and recommended that they should guide all wage fixing authorities, including the Minimum Wage Committee, Wage Boards, and adjudicators:

1. the standard working-class family should be taken to consist of three consumption units for the earner—earnings of women, children, and adolescents should be disregarded
2. the minimum food requirements should be calculated on the basis of the net intake of 2,700 calories, as recommended by Dr Akroyd, for an average Indian adult of moderate activity
3. the clothing requirements should be estimated at a per capita consumption of 18 yards per annum, which means a total of 72 yards for an average worker's family of four
4. in respect of housing, the norms should be the minimum rent charged by the government in any area for houses provided under the subsidized housing scheme for low income groups
5. fuel, lighting, and other miscellaneous items of expenditure should constitute 20 per cent of the total minimum wage

A *subsistence wage* meets only the bare physical needs of a worker and his family. A *minimum wage* provides not only for bare physical needs, but also aims to preserve the efficiency of workers. It also provides for some measure of

education, health, and other benefits. This is the legal minimum wage of the Minimum Wage Act (1948).

Summarizing the trend of minimum wages in India, Anant and Sundaram (1998) made the following interesting observations:

- inter-state variation exists in minimum wages for the same occupation
- significant variation in the minimum wage rates across the occupations or industries exists even within the state
- substantial gaps between revisions of minimum wages in the state
- no uniformity in computation of dearness allowance

One of the reasons for such a variation in inter-state minimum wages is that labour is listed in the concurrent list, as a subject on which both the state and the centre can pass laws.

## Living Wage

Living wage is defined by the Committee on fair wages as, 'one which should enable the earner to provide for himself/herself, and his/her family not only the bare essentials of food, clothing and shelter, but also a measure of frugal comfort, including education for his children, protection against ill-health, requirements of essential social needs, and a measure of insurance against the more important misfortunes, including old age'. In other words, a living wage was to provide for a standard of living that would ensure good health for workers and their family, a measure of decency, comfort, education for their children, and protection against misfortunes. This obviously implies a high level of living.

Such a wage is determined keeping in view the national income and industry's capacity to pay. The Committee was of the opinion that although the provision of a living wage should be the ultimate goal, the present level of national income did not permit the payment of a living wage on the basis of standards prevalent in more advanced countries. The goal of a living wage was to be achieved in three stages. In the first stage, the wage to be paid to the entire working class was to be established and stabilized. In the second stage, fair wages were to be established in the community-cum-industry. In the third stage, the working class was to be paid the living wage. The living wage may be somewhere between the lowest level of the minimum wage and the highest limit of the fair wage. It would depend on the bargaining power of labour, the capacity of the industry to pay, the level of the national income, the general effect of the wage rise on neighbouring industries, the productivity of labour, the place of industry in the economy of the country, and the prevailing rates of wages in the same or similar occupations in neighbouring localities.

Therefore, a living wage should maintain a worker's health and decency, a measure of comfort, and some insurance against the misfortunes of life. In this context, Supreme Court has also laid down following principles for wage fixation.

1. There is a minimum wage, which must be paid in any event, irrespective of the extent of profits, the financial condition of the establishment, or the availability of workers at lower wages.
2. The wages must be fair, which should be sufficiently high to provide a standard family with food, shelter, clothing, medical care, and education of children appropriate to the workers.
3. A fair wage lies between minimum wage and the living wage, which is the eventual goal.
4. Wages must be paid taking into account ground realities of the industry and the region, while also showing due regard to the financial capacity of the unit.

The Bombay High Court has held in two cases that while fixing wages, a broad and overall view of the financial position of the employer must be taken into account.

### **Fair Wage**

According to the Committee on Fair Wages, fair wage represents the wage above the minimum wage, but below the living wage. The lower limit of the fair wage is obviously the minimum wage; the upper limit is set by the capacity of the industry to pay. Between these two limits, the actual wages depends on following considerations:

- productivity of labour
- prevailing rates of wages in the same or neighbouring localities
- level of the national income and its distribution
- place of industry in the economy of the country

Therefore, fair wages are adjustable. They may increase according to the capacity of the industry to pay and the prevailing rates of wages in the area or industry.

## **WAGE BOARDS**

In the 1950s and 1960s, the organized labour sector was at a nascent stage of its development. Trade unions had inadequate bargaining power. The government, aware of the problems which arise in the arena of wage fixation due to the absence of bargaining power, constituted various wage boards. The wage boards are tripartite in character, that is, representatives of workers, employers, and independent members participate and finalize the recommendations. The utility of such boards in the present context are debatable. The wage boards for journalists, non-journalist newspaper and news-agency employees are statutory wage boards; all other wage boards are non-statutory in nature. Therefore, recommendations made by these wage boards are not enforceable under the law.

The importance of non-statutory wage boards has consequently declined over a period of time. Therefore, no non-statutory wage board has been set up after 1966, except for the sugar industry, where such a wage board was constituted in 1985. The trade unions, having grown in strength, are now capable of negotiating their wages with the management. This trend is likely to continue in the future.

In a recent landmark judgement, Supreme Court upheld the recommendations of wage boards for journalists. The newspaper associations, companies, and news agencies challenged the recommendations of a wage board on the ground that newspaper industry although in private sector, still suffers from the brunt of government interference (wage board) in deciding on the compensation of their employees. Against their appeal, the Supreme Court Bench ordered, 'We hold the recommendations of the wage board are valid, based on genuine and acceptable considerations and there is no valid ground for interference.' This recent development once again renewed the role of wage board for adjudicating compensation in select industries.

## WAGE POLICY

With increasing international competition, subsequent to globalization, wage policy issues have now become more important in India. Market globalization and competition has now increased the heterogeneity of organizations, in terms of size, business practices, and culture. This has led to a wide variation in wage or compensation design practices. Concern for international competition now forces organizations to focus on cost and profitability. Currently, employee compensation in India constitutes 36 per cent of the net domestic product; whereas in the organized sector it is 61 per cent. In the organized manufacturing sector in India, wages constitute 9 per cent of the total input costs. Another reason for the study of wage policy has been appropriately identified by Solow (1990) with the observation that, 'Wage rates and jobs are not exactly like other prices and quantities. They are much more deeply involved in the way people see themselves, think about their social status, and evaluate whether they are getting a fair share out of society.'

In India, the government used to play a crucial role in wage determination. This is primarily because of the Articles 39 and 43 of the Constitution of India and the report of the Committee on Fair Wages. As per Article 39, 'The State shall, in particular, direct its policy towards securing that—(1) the citizens, men and women equally, shall have the right to an adequate livelihood, and (2) there is equal pay for equal work for both men and women.' Article 43 states, 'The State shall endeavour, by suitable legislation or economic organization or in any other way, to give to all workers, agricultural, industrial, or otherwise, work, a living wage, conditions of work ensuring a



decent standard of life and full enjoyment of leisure and social and cultural opportunities.’ In line with the constitutional convention, the Committee on Fair Wages (1948) provided guidelines for wage structures in the country. It is based on these guidelines that the concepts of living wage, minimum wage, and fair wages have emerged in India.

At the micro-level, a *wage policy* guides organizations in taking decisions on wage related matters. At the organizational level wage policies are framed keeping in mind the various regulatory requirements, and the organization’s own strategies. Whatever wage policies are framed, the organization should consider the recommendations of the Committee on Fair Wages. These recommendations provide the basic approach for tribunals, wage boards, and others stakeholders to fix wages of workers. The importance of the Committee has been accepted by the Supreme Court in the case of Express Newspapers (Pvt.) Ltd and others versus The Union of India 1938.

Within the boundaries of the fair wage concept, every organization must strive to ensure fair growth in workers’ remuneration. Firstly, the current purchasing power of workers should be maintained against any price rise by providing for adequate neutralization of the rise in cost of living. Therefore, there should be no erosion in total emoluments in terms of their purchasing power.

Secondly, the organization should aim for a reasonable growth in the real earnings of workers and an improvement in their living standards commensurate with their level of productivity, firms’ profitability, and other factors.

An ideal wage and salary policy should

- establish good labour relations
- decide on appropriate wages
- decide wages based on the individual’s capability
- develop a predetermined scheme for payment of wages
- establish linkages of wage payment with performances
- maintain parity of wages with other organizations
- provide for incentive payment
- guarantee minimum wages
- provide for neutralization of price rise
- develop wage structures that can attract talent

A sound wage policy also should adopt a job evaluation programme in order to establish fair differentials in wages based upon differences in job content. Besides the basic factors provided by a job description and job evaluation, following are usually taken into consideration for wage and salary administration:

- organization’s ability to pay
- supply of and demand for labour
- prevailing market rate
- cost of living
- living wage

- productivity
- trade union's bargaining power
- job requirements
- managerial attitudes
- psychological and sociological factors
- levels of skills available in the market

## National Wage Policy in India

International Labour Organization (ILO) has laid down certain guidelines for wage policy. The guidelines emphasize on abolition of malpractices and abuses in wage payment; recommend setting minimum wages even for unorganized workers; suggest for just share to workers, in the form of wages, in the fruits of economic development; and finally, also seek efficient utilization of manpower through desired wage differentials, even recommending introduction of systems of payment by results.

National Wage Policy of India was framed to realize similar objectives. Following are the objectives of National Wage Policy:

1. elimination of malpractices in the payment of wages
2. setting minimum wages to reduce wage differential between organized and unorganized sectors
3. reduce disparities between wages of public and private sector
4. compensate workers for cost of living adjustment
5. reduce the gap between highest and lowest paid workers
6. support trade unions and collective bargaining
7. ensure just share to the workers in the fruits of economic development
8. avoid substitution of capital for labour
9. restrain high profit making units to discriminate wages with high compensation offer
10. institutionalize collective bargaining within national framework
11. encourage incentive payment for increase of productivity and real wages
12. ensure efficient allocation and utilization of manpower through appropriate wage differentials

## Cost to Company

Cost to company (CTC) is defined as the total cost of employment for an individual employee. While issuing the letter of appointment to a new hire, companies detail the CTC, which apart from the gross compensation payable also factors for several benefits, both monetary and non-monetary. Although, rationally CTC is supposed to consider the compensation and benefits related costs, organizational practices vary widely. Internationally, organizations also factor the rent value of office space allotted to an employee as CTC. Even support services enjoyed by executives, say secretarial support are also factored in CTC.

Many multinational companies operating in India even go beyond in factoring such costs—for benefits which are poorly linked to compensation—that is to the CTC. This widens the gap between the CTC and net payable compensation of an employee. Hence, increased CTC may not indicate incremental change in the net salary of an employee. All these are due to absence of some legal mandate in CTC calculation. For example, even a Friday get-together cost during office hours with coffee, though it provides benefit to the company through increased level of employee engagement and helps in developing a performance driven work culture, is factored by some organizations in calculating the CTC. In absence of a legal mandate, industry practices on CTC calculation require some clear guidelines. One possible way is to exclude all overhead costs from CTC. Similarly, costs incurred by the companies to develop employees, say costs of training and development, knowledge management practices, etc., should be excluded from the purview of CTC.

### **Example of CTC calculation**

In absence of any structured guideline and legal connotation, CTC calculation varies from company to company. In many organizations, particularly IT and ITeS, difference between CTC and net pay may be as high as 50 per cent, which often leads to the confusion. Many multinational organizations operating in India take the advantage of showing high CTC to attract the talent. Such compensation package factors most of the variables, which are performance aligned and conditional deferred compensation, which requires employees to continue in the employment for a long period. Based on Indian organizations practices, a standard CTC can be illustrated as under:

**Structured compensation** Structured compensation forms the basis of gross pay. Following are the components of gross pay:

- Basic salary
- Dearness allowance
- House rent allowance
- Food coupons
- Entertainment allowance
- Transport/conveyance allowance
- Medical allowance
- Leave travel allowance (paid with monthly pay)
- Overtime allowance

**Benefits** Structured compensation provides a number of benefits to the employees. These benefits are as follows:

- Provident fund
- Retirement benefit fund
- Insurance
- Gratuity

- Leave encashment
- Club membership

Amongst these benefits, gratuity and leave encashment components are apportioned on monthly basis.

CTC in this case would be the structured compensation/gross pay + the benefits. For example, ICICI Bank for their campus hire (law graduates) provides for CTC of ₹9.05 lakh per year. The bank includes loans, assistance for housing, pensions, and various other benefits in calculating CTC.

## Base Pay Calculation

Base pay is the core component of compensation packages. It is the pay for standard job duties, roles, and skills. Other top-ups on compensation vary with respect to the base pay. For employees, perspective base pay is important, as it is the fixed component of compensation. Most of the top-ups on base pay are known as variables, and are often aligned with the performance of employees and of the organization. Some are statutory in nature, say provident fund, gratuity, etc.; whereas others are voluntary. Similar to CTC, base pay design and calculation also vary across the organizations. It involves several contributing factors and strategic choices. Internationally, we find base pay is deliberately kept low by the companies, and more emphasis is given on variables. In India also, base pay varies across the organizations, and it hovers around 50 per cent of the total compensation or gross pay.

Some of the important objectives of base pay are; internal and external equity, compliance with legal provisions, individual and process equity, and efficient utilization of the compensation budget. Base pay designing requires job analysis and evaluation, labour market data analysis, and decision on pay ranges.

Based on the industry practices, factors contributing to the base pay calculation are

**Strategic or competitive positioning of the organizations** The degree of need for talent acquisition and retention also plays a role in companies decision on the base pay level. A talent driven organization provides for more base pay, as employees look for those employers who are more transparent with long term commitment in institutional employment. Such companies with a broad band pay structure can differentiate the base pay across the employees, depending on their knowledge and skill, and performance level.

**Industry practices** Companies can decide on the base pay levels based on the industry benchmarks. For this purpose, they also make use of compa-ratio or comparative ratio. We have discussed compa-ratio separately in this chapter.

**Legal mandates** Although we do not have specific legal mandates on base pay calculation, companies, particularly in India, cannot decide on base pay below the level of statutory minimum wages.

**Organizational life cycle** Depending on the life cycle stage, that is, start-up, growth, maturity, decline, and decision on base pay varies across the organizations.

For example, sales compensation for the start-up may offer less base pay and more variables, based on the contribution margin. The same organization, however, to stabilize growth may offer more base pay for retention of high performers.

**Competency-based base pay** Depending on the level of competency, companies may decide on the base pay. With wide competency gap between the required set of competencies for the employees and available competencies of employees, base pay may be reduced.

**Labour market dynamics** When demand for a particular profession or occupation group is higher than the supply of available workforce, companies may raise the base pay. In the reverse cases, base pay may get reduced.

Hence, it is evident that decision on base pay for any organization depends on multiple factors.

## Compensation Philosophy

Effective management of compensation function requires a structured plan. Many organizations develop and document such compensation plans, partly to meet the requirements of legal compliance, and partly to achieve the strategic intents such as employee satisfaction, motivation, and retention. Compensation plan encompasses clarity on compensation philosophy, approaches to base pay design, decision on pay rates for various categories of jobs, job evaluation, performance management systems (PMS), process of reviewing compensation from time to time, etc.

Compensation philosophy consists of a bunch of guiding principles that form the basis of compensation design. It helps in developing a compensation plan that the organization intends to achieve through compensation. When such goals are to attract and retain the talent, create a performance driven work culture, motivate employees, and elicit desired behaviour from employees, a compensation philosophy is developed, which caters to all these aspects. To the contrary, when goals are to gain incremental change in performance and productivity, the approach to compensation philosophy is more opportunistic and oriented towards short-term gains. However, there are some organizations which have a system of communicating the compensation philosophy and plans to their employees, and even go to the extent of involving employees in framing the compensation plans. For example, TCS ensures employees' compensation and benefits are aligned with the global demographic diversity, and allow employees to have their say in defining their compensation and benefits programme. Compensation philosophy may also outline the modalities in framing decisions on compensation design. For example, companies may decide on their relative market position in compensation, choosing market level pay, below market level pay, or above market level pay. Again such decisions are aligned with their strategic and business goals. Compensation philosophy of a company may also incorporate their choice of mix between cash and benefits

component of compensation, mix between fixed and variable pay, process of performance evaluation system, legal mandates, etc.

Using a sample compensation philosophy of a hypothetical company, we can describe a compensation philosophy of XYZ company from operational perspective.

Our compensation philosophy/plan rests on following principles:

- attracting and retaining talent
- pay at market rate for 80 per cent of employees who meet expectations
- pay 20 per cent above market rate for 20 per cent of employees who exceed expectations
- highly competitive compensation, and benefits among peer group companies
- internal equity in compensation plans
- provision for employee rewards
- cognizance to internal financial strength
- focus on competency and performance-based compensation
- strict adherence to legal provisions

The above compensation philosophy helps us to achieve high performance growth, acquisition and retention of talent, high employee motivation, and adherence to legal provisions.

### **Compensation planning**

Compensation planning is deciding on employees' compensation for acquiring, maintaining, and retaining the human resources of an organization, so that they can feel motivated and become productive for organizational sustenance and growth. Effective compensation planning ensures individual, internal, and external equity. Individual equity establishes equal pay for equal job. Internal equity maintains balance in compensation structure within the organization. External equity on the other hand calibrates compensation with the labour market. Following are some important objectives of compensation planning:

1. Attracting talent
2. Retaining talent
3. Maintaining pay equities
4. Encouraging innovation through rewards
5. Compiling with legal provisions
6. Ensuring compensation cost optimization

We operate in a globally competitive market. Our compensation objectives are to attract and retain talented employees. We design our employees' compensation packages integrating the organizational and individual performance, respecting equity, law of the land, and our business goals. Broadly, our compensation objectives help us to design our compensation policies and practices encompassing the following areas:

1. attracting, retaining, and motivating talented employees, who drive our business results with competitive compensation

2. provisioning for more variable pay based on performance
3. validating compensation in alignment with measurable performance results
4. customizing compensation packages based on employees' needs, without exceeding the overall compensation amount
5. calibrating compensation with shareholders' value creation
6. ensuring total cost of compensation is in accordance with the company's affordability
7. using compensation policy as an important tool to communicate to employees our performance standard

### **Pay grades and pay bands**

Most of the structured organizations follow some well defined pay grades, depending on the job responsibilities and job descriptions of employees. Each employee on his employment in the organization is placed in a specific pay grade, which indicates the amount of salary that he will receive within a pay band. Pay bands are broader than pay grades, as it incorporates several pay grades. It means two or three pay grades in an organization may be incorporated in a pay band. An employee is put in a pay grade of a pay band depending on his work experience, knowledge, and skill level at time of recruitment. Therefore, a pay band distinguishes compensation amount between several ranges of jobs, whereas a pay grade differentiates compensation within a job range. This we can illustrate using Table 1.1.

Interpreting Table 1.1, we can understand that within the same pay band, that is, PB-2, we have several grades. The compensation between such grades within the same pay band is differentiated in terms of grade pay. Grade pay is considered along with the base or basic pay for calculation of dearness allowances, when payable. Although, such differences are minimum for government organizations; they can be more for private organizations. For example, Walmart puts interns and store associates in the same pay band. Their compensation is fixed at the given pay band, but their pay varies widely depending on the grades.

**TABLE 1.1** Pay band and pay grades

Grade	Pay band (PB)	Scale (in ₹ per month)	Grade pay (in ₹ per month)
Assistant executive engineer	PB-2	9,300-34,800	4,800
Private secretary	PB-2	9,300-34,800	4,600
Junior works manager	PB-2	9,300-34,800	4,600
Assistant staff officer	PB-2	9,300-34,800	4,200
Personal assistant	PB-2	9,300-34,800	4,200
Chargeman-Non technical	PB-2	9,300-34,800	4,200
Chargeman-Technical	PB-2	9,300-34,800	4,200
Junior hindi translator	PB-2	9,300-34,800	4,200

Source: Compiled from various reports of Central Government 6th Pay Commission

Nowadays, many organizations go for a flat structure to reduce hierarchical levels. Such an arrangement reduces the levels and thus the promotional opportunities. On the other hand, with flat organizational structure, organizations can implement shared decision-making on a larger scale. From the compensation management point of view, such structure require consolidation of various pay bands and pay grades into broader pay ranges, this is referred as broad banding of pay. Such wide pay band facilitates systematic pay increases, even though employees get limited promotional opportunities. Particularly in large hierarchically structured organizations, it becomes often necessary to reduce the levels, merging several levels into one, without impairing the compensation systems. In a broad band pay structure, employees can be put at a suitable pay level, which would have been their eligibility in a narrow band pay structure depending on the knowledge, skill, and performance levels of employees.

Using the two charts shown in Figs 1.1 and 1.2, we can explain the broad banding. Y-axis here indicates the pay band, and x-axis indicates compensable factors. In traditional pay structure, we find multiple pay bands, whereas broad band pay structures have fewer pay bands.

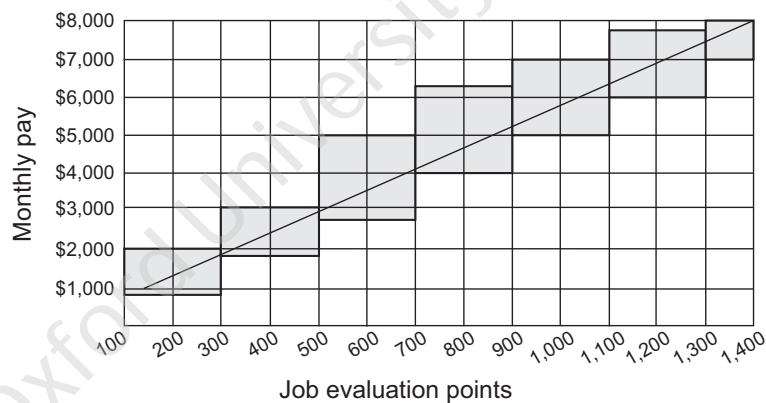


FIG. 1.1 Traditional pay structure

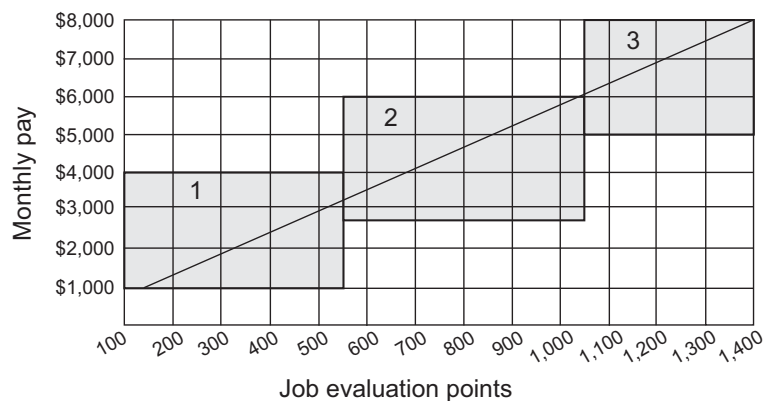


FIG. 1.2 Broad band pay structure



## SIGNIFICANCE OF EMPLOYEE COMPENSATION

Compensation basically represents an employment contract. It is important to employees, organizations, and the economy. To an employee, pay is a primary reason for working. For some individuals, it may be the only reason. For most of us, it is the means by which we provide for our own and our family's needs.

Compensation is also important for organizations. It represents a large proportion of expenditure of an organization. In manufacturing firms, it is seldom lower than 20 per cent; in service enterprises, it can be as high as 80 per cent. Even more importantly, organizations try to accomplish many goals through compensation. These goals include attracting and retaining people, and motivating them to perform more effectively. Compensation is also significant in the operation of the economy as salaries and wages are the largest contributing factors to the national income of many countries in the world, including India. Hence, it is important for us to understand different theories applicable to compensation.

### ***Economic concept***

Compensation is a price for a factor of production. It serves to allocate scarce human resources for productive uses. To the employer, compensation is the price paid for labour services. As an economic concept, compensation is governed by the same logic as any other purchase by a firm. An organization strives to get the greatest quantity and the highest quality for its money. By the same logic, the worker is selling labour services to obtain income and holds out for the highest price obtainable. The actions of these buyers and sellers are supposed to set the price and to allocate labour (employee services) to its most productive use.

The market for labour services differs in many ways from the market for commodities. Labour service is perishable. If today's labour is not purchased today, it may have no value tomorrow. Besides, labour service may vary from hour to hour and day to day because it varies with the ability of a person to work. Furthermore, the labour supplier cannot be separated from the labour services supplied as he can change the quality and quantity of those services. In the labour market, the pay for similar work tends to be equal. Differences in pay between occupations only reflect scarcities for which the market had not had time to adjust, or the actual differences in ability.

Therefore, economic analysis is essential in any study of compensation. However, the differences between labour markets and other markets suggest that economic analysis alone is not sufficient.

### ***Psychological concept***

Compensation or pay represents the psychological contract between an individual and the organization. An organization's reward practices can only have

consequences through this contract. Therefore, pay as a psychological concept is pay viewed from an individual's standpoint.

The factors that go in determining an individual's behaviour are situation, needs, perception, and attitude. However, the situation and the individual are not independent as the situation depends on the individual's perception of it. Needs that are felt states that they influence as well as are influenced by perceptions. The means for satisfying needs are those perceived by individuals and interpreted through attitudes. One need may be satisfied by a number of means and one mean may satisfy a number of needs. Relating compensation to the psychological concept complements the economic perspective by taking into account the perceptions of individuals.

### **Compensation and behavioural issues**

Compensation management is an application of motivation theory. For this reason, motivation theory can be considered as a form of compensation theory. Here, our focus is just to establish the link between motivation and compensation administration.

Psychologists have focused on two psychological processes of motivation—arousal and choice. Arousal is the reason why people do anything and choice refers to the choices that people make. Similarly, we can distinguish between content and process theories of motivation. *Content theories* focus on the factors that motivate behaviour. It centers on needs or drives. Therefore, it is linked with arousal process of motivation through compensation designing. *Process or choice theories* explain the operation of motivation, or the factors that influence an individual to choose one action over another. *Process theories* can be subdivided into cognitive and non-cognitive approaches. Cognitive theories see behaviour as involving some mental process. Non-cognitive theories see behaviour as caused by environmental contingencies. The major cognitive theories are equity theory, goal-setting theory, and expectancy theory. All these theories focus on perceptions of the outcomes that flow from behaviour. Non-cognitive theories do not focus on what goes on inside the person's brain. Instead, they claim that it is the environment that determines the behaviour of the person. Therefore, to control behaviour, one must control the person's environment.

Compensation designing acts as operant conditioning, as employees show two types of behaviour—respondent and operant—while their behaviour gets reinforced. *Respondent behaviours* are controlled by instincts and direct stimulation. *Operant behaviours* are displayed in the absence of any apparent external stimulation.

### **Sociological concept**

Pay can be a status symbol within organizations and society. In less complex societies, the status of individuals is a product of many standards of judgement. For example, their families, friends, occupations, education levels, and

religious and political affiliations. In large, mobile societies, many of these standards are harder to measure and become less significant. Income, as a symbol of status, does not present this problem. Organizations create status structures of jobs. Status differences are measured by both organizations and individuals in terms of pay and pay differences. In fact, employees learn to place associates in the status structure of the organization according to how much they are paid.

Viewing compensation as a sociological concept focuses neither on the organization nor on individuals, but on the relationship between them. The mutual influence of individuals, organizations, and of groups within and without constitutes another dimension of compensation decision-making.

### **Political concept**

Compensation as a political concept involves the use of power and influence. Organizations, unions, groups, and individual employees all use their power to influence pay. Unions exert influence at the time the contract is entered into, and during the life of the contract, through the grievance procedure. Similarly, compensation in unionized organizations influences that of non-union organizations. A political perspective stresses on accommodating the influence of all parties.

### **Equity concept**

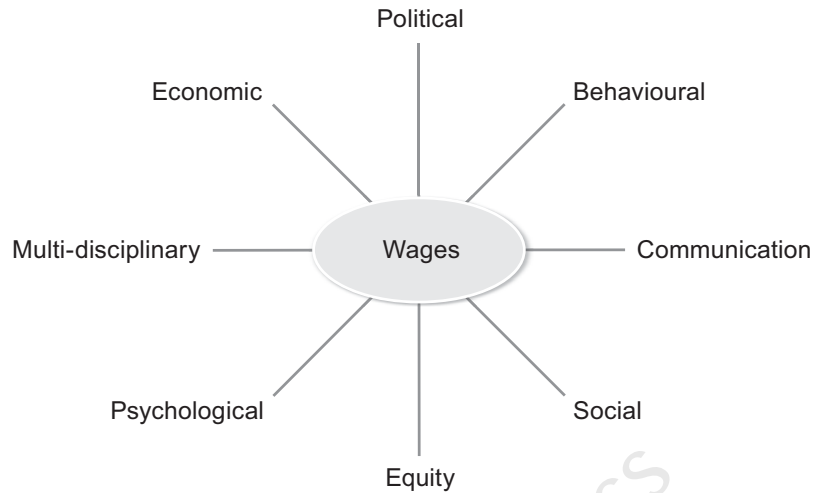
Few discussions of compensation are conducted without repeated appeals to fairness. Phrases such as *a fair day's pay* or *the just wage* are common. In both cases, the equity sought is distributive justice. The foundation concept is that returns should be proportionate to contributions. Viewing compensation as an equity concept means analysing pay from the separate viewpoints of the parties. Ideally, compensation should be adjudged fair by all of them.

### **Communication concept**

Compensation is drastically affected by communication, particularly in this electronic age. Employees now have easy access to the competitive rates commonly paid for their positions within any given geographic area. Worldwide, employers now face a future where employees know more than their employers about the value of their positions in the competitive marketplace.

### **Multi-disciplinary concept**

Economists have focused on the price (wage) of a factor of production and, considered employee behaviour in terms of labour units employed (typically in terms of working hours). Psychologists have focused on the needs of individuals and the means by which they may be met by organizations, with less emphasis on the needs of the organization. Sociologists, political scientists, and philosophers have often not studied compensation per se, but concepts



**FIG. 1.3** Integrated Model of Compensation

they have developed for other purposes may be usefully applied to the study of pay. Management researchers and teachers have focused on the more esoteric aspects of compensation; few have focused on the ability to control costs. Those in separate disciplines have thus studied compensation selectively (see Fig. 1.3).

## ETHICAL ISSUES

Ethics is the science (study) of morality. Ethical behaviour is about deciding what is right or good. It is often called moral philosophy. It emanates from value theory, that is, axiology. Other branches of ethics are aesthetics, metaphysics, epistemology, and logic.

Compensation management practices in any organization need to be ethical. Since many organizations align their incentives and variable pay components with performances, both at the individual and organizational level, it is often seen that organizations try to manipulate their performance metrics, without considering ethical issues. It may be imperative for organizations to optimize compensation cost to remain competitive in the market, but resorting to such practices is considered unethical. Even world-class organizations such as Wal-Mart often face this dilemma. To deal with this problem, organizations are now adopting separate codes of conduct for compensation management practices. Building a value-based organizational culture at the outset is the foundation of compensation ethics. Organizational values permeate workplace practices, letting people share such values in their day-to-day performances. Ethical organizations care about their people and even go beyond statutory limits when paying compensation and benefits. For example, Tata Steel in India pays compensation and benefits beyond the statutory limits.

## Bases for Compensation Ethics

Every organization has a vision. This vision encapsulates its values, which translate into the long-term goals of the organization. It essentially guides the behaviour of the people working with the organization. Its vision also translates into the organization's current purpose, or mission. Both the vision and mission influence the daily decision-making and practices of the people working with the organization. Therefore, for every organization, core compensation ethics emerge from its vision and mission.

Compensation ethics also depend on the choices of the organization. Organizations may choose to be proactive in their human resource management practices, or reactive and traditional. With proactive choices, organizations become ethical in people management issues, as well as compensation. On the contrary, reactive practices focus on individuals acting in a self-defined vacuum, so ethical issues are often violated.

Compensation ethics also need to be aligned with the strategic choices of the organization. Strategic choices may differ from employee to employee, primarily on hierarchical level, performance criteria, the nature of the job, and the type of skill sets. Many Indian organizations, particularly in the IT sector, indulge in discriminatory compensation practices.

If the organization embraces compensation ethics, in the form of a structured code of conduct, it will inevitably ensure the following changes in the behaviour of its employees:

- work-related behaviour, decision-making styles, and interpersonal interactions will reflect ethical values
- organizational decisions based on values and ethics will help make people more cooperative
- compensation and rewards will become more structured
- organizational goals will be aligned with ethical practices
- regular performance feedback to people will help in continuous development
- human resources practices will become more congruent with values

In the case of employment matters, compensation ethics help in ensuring that the work environment is free from all forms of harassment, intimidation, or coercion. Recently, serious charges were levelled against global companies such as Citigroup and Merrill Lynch for unethical compensation practices. The CEOs of both these companies had to quit because of a drop in business, but both received huge accumulated benefits (even without their severance pay). Therefore, unethical compensation payouts, especially disproportionately large payouts to senior executives, have now become common in many organizations.

Many organizations set up their own ethics committees to monitor whether prescribed ethics are being strictly followed in the day-to-day activities of the organization. They systematically conduct ethics audits, ethics training, and even set up ethics hotlines to ensure that employees follow the ethics and values of the organization.

## SUMMARY

Wages and salary administration is major human resource management function today. Apart from compliance with procedures and regulations, aspects such as cost to the organization and employee motivation also need to be considered. Human resource managers need to consider the trade-off between these considerations. Administration professionals, on the other hand, have to take care of payroll.

In percentage terms, salary, wages, and bonus taken together are still the major causes of industrial disputes in India. Hence, determining wages based on certain defined methodologies should receive priority. Linking wages to performance is again a major issue. Suitable incentive schemes need to be identified to reward good performers. Fringe benefits are another major instrument to motivate employees. With increased competition, the organizations need to become innovative in designing employee compensation. This has led to compensation becoming more and more interlinked with talent management.

Compensation is a methodical approach to assigning a monetary value to employees in return for work performed. Various factors—both external and internal—influence compensation. The term compensation is used to describe not only employees' salaries, but also all other benefits they receive. It is also referred to as remuneration. However, compensation is a more holistic term than remuneration. Traditional wages and salary administration has now started losing ground. Just complying with statutory norms and expecting employees to deliver results does not hold good in today's competitive scenario. Hence, organizations have to design compensation in such a manner that it should act as a reward rather than just a monthly salary for the job done. They also have to come up with comprehensive compensation planning that includes considerations such as pay grades and pay bands and cost to company (CTC) for individual employees. Though organizations vary widely in their approach to compensation planning, their compensation management practices should be ethical and guided by the organizational vision.

### Key Terms

**Assessment centres** One of the modern methods of performance appraisal. This method tests candidates in a social situation by a number of assessors, using a variety of criteria. This method is useful in measuring inter-personal skills, organizing and planning ability, creativity, resistance to stress, work motivation, decision-making power, etc.

**Dearness allowance** These allowances are paid to protect the real wages of employees from falling in value, by keeping pace with the price rise.

**Employee stock options (ESOP)** A type of employee benefit plan which is intended to encourage employees to acquire stocks or ownership in the

company. ESOPs are often used as a corporate finance strategy and are also used to align the interests of a company's employees with those of the company's shareholders. These are offered as incentives by the organization to ensure increased level of motivation and retention of employees.

**Fair wage** It is the wage, which is above the minimum wage, but below the living wage. The lower limit of the fair wage is the minimum wage and the upper limit is set by the 'capacity of the industry to pay'.

**Job evaluation** Process of measuring the relative worth of a job to decide the wage rate.

**Key result areas (KRA)** These indicate the performance target of individual employees of an organization. These are aligned with business goals.

**Living wages** It is a wage rate which not only provides the bare essentials of food, clothing, and shelter, but also a measure of frugal comfort for the worker. It also provides for his children education, protection against ill-health, requirements of essential social needs, old age, and a measure of insurance against the misfortunes.

**Minimum wages** They are need-based and statutorily decided both by the central and the state

government. Payment of minimum wages is obligatory for an organization.

**Performance management systems** System of integrating individual employee performance with the performance of the organization.

**SMART** Specific, measurable, attainable, realistic, and time-bound goals.

**Time study** It is carried out to decide the standard time required to perform a job and then base the wage and incentives on the same standards.

## Exercises

### Concept Review Questions

1. Explain the concept of employee compensation management. What is its significance?
2. What are the important compensation domains? Which domain do you feel influences compensation design in India?
3. Explain a compensation decision model and its determinants.
4. Identify the possible factors to justify an increment in your organization.
5. Discuss the important elements of employee rewards.
6. Write short notes on:
  - (a) Broad band pay
  - (b) Compensation benchmarking
  - (c) ESOPs

### Critical Thinking Questions

1. A particular organization, engaged in the business of pharmaceutical drugs, offers the best salaries in the industry to its employees. The company has started losing talented employees due to increase in inter-industry job mobility. Initially, the company did not pay any attention to this issue, as it can get skilled manpower from its relatively small competitors, because of its competitive compensation package.

However, its talent flight has now become so acute that the company has decided to opt for an industry benchmark of their compensation packages. As a team leader of this project, chalk out your action plans detailing the types of industries that you may like to benchmark.

2. Prepare a wage policy for payment of wages to industrial workers.



### New Delhi Shopping Point

New Delhi Shopping Point has about 300 employees, 200 of whom are on the permanent rolls, whereas the rest are outsourced. About 50 per cent of the employees were females. Since it was a new entrant in the business, the retail chain has adopted the

ongoing practice of job evaluation rather than framing its own job evaluation and classification system. As a result, the chain failed to establish a mutually agreed compensation design plan and was accused of deliberate pay inequity, without valuing diversity issues. This institutional

(Contd)

**CASE STUDY** (Contd)

failure to establish pay equity ultimately led to successive strikes by dissatisfied employees. Eventually, these employees formed unions with strong opposing political affiliations.

The company then formed a task force with cross-functional team managers to educate employees on the methods of job correlation and job pricing. The idea behind the force was to receive the support of employees to develop a mutually accepted job evaluation scheme and rationalize the company's pay differentiation strategies. Although this scheme might have reduced the employees' dissatisfaction on pay parity, it failed to eliminate inequity, resulting in dissension amidst a small section of employees.

In a retail store, customers notice dissatisfied employees immediately, especially when their queries go unheard, when they are left to guess the price of an item whose price tag is missing, or when they are not properly informed about product features. The business of a retail chain suffers when it fails to captivate customers. The New Delhi Shopping Point faced all these predicaments, resulting in a substantial loss of business and significant reduction in customers.

Facing successive business losses, the company ultimately decided to discuss the pay parity issue and to arrive at a solution. It also agreed to develop a suitable job evaluation scheme, aligned with the compensation design plan. All the unions agreed to this proposition of the company and promised to come out with a win-win solution on the pay parity issue. Some of the issues suggested by unions for discussion in the joint meeting were—correctly capture some key features of work done by female employees, differentiate between the quality of customer relations offered by a male and female employee, understand the success rate (in terms of percentage of customers) of male and female employees, etc. A section of female employees complained that though their success rate was better than their male colleagues, they were still paid less than their male counterparts. They threatened to refer the matter to the Human Rights Commission, if conciliation failed.

**Discussion question**

As a team member, representing the management, suggest a way for the company to achieve pay parity through mutual consensus.

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