

CHAPTER 2

STRATEGIC PERSPECTIVES

LEARNING OUTCOMES

After studying Chapter 2 students should be able to:

- Explain why managers should tailor their pay systems to support the organization's strategy. Identify the four steps to develop a total compensation strategy.
- Describe the three tests used to determine whether a pay strategy is a source of competitive advantage.
- Contrast the "best fit" perspective on compensation with the "best practices" perspective.

CHAPTER SUMMARY

1. The four steps to develop a total compensation strategy are: (1) assess total compensation implications, including business strategy and competitive dynamics, HR strategy, culture/values, social and political context, employee/union preferences and fit with other HR systems; (2) map out a total compensation strategy; (3) implement the strategy; and finally, (4) assess and realign the strategy to ensure achievement of the objectives.
2. To improve organizational effectiveness, managers should align the compensation strategy to the organization's strategy.
3. The three tests used to determine whether a pay strategy is a source of competitive advantage are (1) Does it align? (2) Does it differentiate? And (3) Does it add value?
4. The "best fit" perspective on compensation suggests that compensation be aligned, or fit. With the specific business strategy adopted by the organization, given its environment, in order to maximize competitive advantage. The "best practices" perspective suggests there is one set of best pay practices that can be applied universally across situations and strategies, attracting superior employees who then create a winning strategy.

LECTURE OUTLINE

SIMILARITIES AND DIFFERENCES IN STRATEGIES

Sometimes different business units within the same corporation will have very different competitive conditions, adopt different business strategies, and thus use different compensation strategies. *As seen in Exhibit 2.1* the compensation strategies for Google, Medtronic, and Merrill Lynch are compared and contrasted to demonstrate inter-company differences along the dimensions of objectives, internal alignment, external competitiveness, employee contributions, and management. In addition to inter-company

differences, compensation strategies are also diverse within the same industry as can be seen with Google, Microsoft, and SAS. They collectively compete from the same pool of candidates so it is important for each company to differentiate itself from its competitors. Finally, compensation strategies can vary within the same company pending the types of jobs and their linkage to industry compensation norms. A strategic perspective on compensation is more complex than it first appears. Taking a **strategic perspective** requires a focus on compensation decisions that help the organization gain and sustain competitive advantage.

At Nucor Steel, the emphasis is on high productivity, high quality, and low cost products. In a good year an hourly worker can make \$75,000 or more per year.

Merrill Lynch has pay objectives consistent with reliance on the human capital of its employees to complete, and therefore uses competitive base pay, aggressive bonuses, and stock awards based on individuals' accomplishments.

STRATEGIC CHOICES

Compensation strategies require many critical decisions that are ongoing as opposed to static and fixed once struck. It is important to understand the relationship between strategy and competitive advantage. Ultimately an effective strategy will produce competitive strategy for the business. In determining strategy, key questions that need to be asked include:

1. What business should we be in?
2. How do we gain and sustain competitive advantage in this business?
3. How should HR help us win?
4. How should total compensation help us win?

See Exhibit 2.2 to see how these questions can be aligned with strategic choices.

Strategy refers to the fundamental business decisions that an organization has made in order to achieve its strategic objectives, such as what business to be in and how to obtain competitive advantage.

Competitive Advantage is a business practice or process that results in better performance than one's competitors.

What should the Compensation System Support?

- Support business strategy
- Support HR strategy

Support Business Strategy

The most common choice is that the compensation system should support the business strategy at the very least because the ultimate purpose of a business strategy is to gain and sustain competitive advantage. As business strategies change, compensation systems

need to change (e.g., IBM's strategic and cultural transformation.) Some typical strategic frameworks include **Porter's model** and *Miles and Snow*.

See Exhibit 2.3 to review how different compensation strategies might be tailored to three general business strategies.

Support HR strategy

It is logical to assume that the business strategy is created first prior to the HR strategy. Once the HR strategy is in place, the compensation system can be generated. The processes of recruiting and selecting, retaining, rewarding, compensating and motivating employees are linked to the HR strategy. For example, SAS keeps turnover low by having generous benefits as opposed to having the highest salaries.

THE PAY MODEL GUIDES STRATEGIC PAY DECISIONS

The Pay Model from Chapter 1 can be used to assess the strategic compensation decisions along the following dimensions:

1. **Objectives:** How should compensation support the business strategy and be adaptive to the cultural and regulatory pressures in a global environment?
2. **Internal alignment:** How differently should the different types of levels of skills and work be paid within the organization?
3. **External competitiveness:** How should total compensation be positioned against competitors?
4. **Employee contributions:** Should pay increases be based on individual and/or team performance, on experience and/or continuous learning, on improved skills, on changes in cost of living, etc.?
5. **Management:** How open and transparent should the pay decisions be to all employees?

Stated versus Unstated Strategies

All organizations that pay people have a compensation strategy. Some may have written, or stated compensation strategies for all to see and understand. Others may not even realize they have a compensation strategy (unstated strategy), claiming that "We do whatever it takes."

Review Exhibit 2.4 for Key Steps in Formulating a Total Compensation Strategy

DEVELOPING A TOTAL COMPENSATION STRATEGY: FOUR STEPS

Step 1: Assess Total Compensation Implications

Business Strategy and Competitive Dynamics

Organizations need to understand the industry in which they operate and with which they compete. Competitive dynamics can be assessed globally. Pay comparisons between countries are difficult because of different practices and different priorities.

See Exhibit 2.4 to review the key steps in formulating a total compensation strategy.

HR Strategy: Does Pay Play a Supporting Role or a Catalyst for Change?

Compensation must fit the HR strategy so functions like performance systems support the HR strategy. A flexible compensation system can be used to activate changes to the HR strategy.

Culture/Values

Pay systems should be consistent with the overall organization's philosophy about the way it does business and the way it treats employees in the organization.

See Exhibit 2.5 for an example of the Medtronic Mission and Values statement.

Social and Political Context

Due to legal and regulatory requirements, cultural differences and changing work force demographics, expectations take on new meaning in a global context.

Employee Preferences

Employees are different with different preferences. Pay systems can be designed to reflect these preferences by increasing flexibility in the system.

Union Preferences

The influence by unions on pay systems remains significant in Canada. Unions are major players in Europe. The organization must consider union desires and work to design a pay system that will accomplish its goals while satisfying the union.

Step 2: Map a Total Compensation Strategy

.NETWORTH

Netflix: Freedom and Responsibility in Rewards is described in the chapter. Netflix is a global provider of streaming movies and TV series with over 75 million subscribers. Its strategy is all about innovation and its corporate culture emphasizes freedom and responsibility.

Compensation strategy is formulated on the five decisions outlined in the pay model:

- 1) Set objectives
- 2) Specify four policy choices of:

- a) internal alignment
- b) external competitiveness
- c) employee contributions, and
- d) management.

Steps 3 and 4: Implement the Strategy and Reassess the Fit

Step 3 includes implementing the strategy via the design and execution of the compensation system. This means to essentially take the plan from the strategy and make it come to life in practice.

Step 4 reassesses the fit from changing conditions and realigns the strategy to close the loop. Reassessing the fit offers the opportunity to continuously learn, adapt and improve.

SOURCE OF COMPETITIVE ADVANTAGE: THREE TESTS

There are three questions that are aligned with three tests of competitive advantage including the following:

- 1) Is it aligned?
- 2) Does it differentiate?
- 3) Does it add value?

Align- with the business strategy, externally with the economic and socio-political conditions and internally within the overall HR system.

Differentiate- sustained competitive advantage comes from how the pay system is different from others. One important aspect of competitive advantage is that it will strengthen if the pay system is unique and cannot be copied.

Add Value- finding ways to calculate the return on investments from incentives, benefits and base pay. This approach supports a compensation system that focuses on human capital as the recipient of investments which can be dehumanizing for some. Of all the tests, adding value is the most difficult.

“BEST FIT” VERSUS “BEST PRACTICES”

The underlying premise of designing any pay system is that if the system reflects the organization’s strategy and values, and is responsive to both external considerations and internal employee needs, it is more likely to be successful in achieving its objectives.

“Best Fit”

The basic underlying premise of any strategic perspective is whether managers align pay decisions with the organization’s strategy and values, and are responsive to employees and union relations, while remaining globally competitive. The organization is more likely to achieve competitive advantage. The challenge is to design the “fit” with the environment, business strategy, and pay plan; the better the fit, the greater the competitive advantage.

“Best Practices”

Some believe that (1) a set of best practices exists, and (2) these practices can be applied universally across situations. Adopting best pay practices gives employer preferential access to superior HR talent. This talent, in turn, influences the strategy the organization adopts and be a source of competitive advantage. But many writers advocate their own view of what are “best practices.”

GUIDANCE FROM THE EVIDENCE

Research supports that specific pay strategies are only relevant under certain contextual boundaries. The most important question is to ask: *“What practices pay off best under what conditions?”*

VIRTUOUS AND VISCIOUS CIRCLES

Two examples of best practices include performance-based pay and stock options grants. In a virtuous circle (*see Exhibit 2.613*), performance-based pay works best with an effective and productive organization. On the contrary, when an organization is not performing well, a vicious circle results and performance-based pay becomes ineffective.

REVIEW QUESTIONS

- 1. Read again the values statements in Exhibit 2.5. Discuss how, if at all, these values might be reflected in a compensation system. Are these values consistent with “let the market decide?”**

Medtronic’s statement lauds stability, so one would expect a developed internal structure. However, because the company depends on research and its development into high-quality products, it also needs enough internal flexibility so as to permit creativity and innovation. The culture of the company describes a very nurturing environment that would offer substantial relational returns from work. External competitiveness and “market” issues may be dealt with through “sharing the company’s success.”

- 2. What are the three tests used to determine whether a pay strategy is a source of competitive advantage? Discuss whether these three tests are difficult to pass. Can compensation really be a source of competitive advantage?**

The three tests are:

- 1) Is it aligned?
- 2) Does it differentiate?

3) Does it add Value?

A compensation system adds value if it allows the company to attract, retain and motivate the kinds of employees and behaviours that will help it achieve its goals. It must do so in a cost-effective manner, so that the company is not at a cost disadvantage in marketing its goods and services.

While all companies seek to achieve this same outcome, a strategy can still be difficult to imitate if it is uniquely designed to fit with the organization's business strategy and other HR activities (recruiting, training, employee relations, etc.) and is implemented fairly.

3. Contrast the essential difference between the “best fit” (strategic business-based) and “best practice” perspectives on compensation.

A strategic, business-based approach says that compensation decisions (and all HR decisions) should be made with the unique characteristics of the company, its employees and its environment in mind, and should be based on how they can help the company achieve its business objectives.

A best practice approach says that certain practices are simply superior in all settings. These practices have been proven in certain companies and efforts should be spent on disseminating them throughout the workplace.

4. Explain why performance-based pay may not always be a best practice.

In a recession or economic downturn, performance-based pay would not be a best practice because the employees would get minimal compensation if the company is performing poorly. Other methods of generating compensation for employees must be used as a best practice like putting more emphasis on non-monetary benefits.

EXPERIENTIAL EXERCISES

- 1. Interview a compensation specialist about his or her organization's compensation strategy, specifically the five issues – objectives, internal alignment, external competitiveness, employee contributions, and management. How does this organization compare to Google? To Whole Foods? What business strategy does it seem to fit (i.e., cost cutter, customer-centred, innovator, or something else)?**

Student answers will vary depending on their ability to find compensation specialists.

- 2. Set up a debate over the following proposition: “Best Practices” is superior to the “Best Fit” approach when designing a compensation system.**

Although the case is made in the text for business-based approach, proponents of best practice approach can point out the limited research on strategy that supports a business-based approach as well as the narrow range of strategies. For example, almost all companies claim to pay “above the market” and to have systems that “value fairness.” Proponents of best practice could make the case that what we actually have is generally accepted practice rather than strategy. The real issue, then, is to make that “generally accepted” practice the “best” practice.

3. Survey ten people about their total rewards preferences. What conclusions can you draw from the results?

Student responses will vary. Refer to chapter 1 and list the potential total rewards in a chart for easy tabulation. Note differences using demographics (age, gender, etc.), years of work experience, family responsibilities, education and other contextual information.

4. Set up a debate over the following proposition “Nonfinancial returns are more important than pay.”

Student responses will vary. Consider nonfinancial returns including a great place to work, opportunities to learn, job security, and flexible work schedules. To focus solely on pay when there is high job insecurity would not be relevant. Flex-time would be more desired by parents with small children.

CASE - Difficult to Copy? .NETWORTH

Questions to consider:

- 1. Spend some time looking at the website for Netflix. What can you infer about the business strategy and the organizational culture?**
- 2. What external pressures do you think Netflix faces?**
- 3. Decide whether you think the compensation strategy of Netflix fits its business strategy, organizational culture, and external pressures.**
- 4. How would you change compensation at Netflix?**

Discussion

Netflix created a working culture that is transparent, values its values as well as a hard working, team-oriented “no jerks allowed” employment policy. It is also a culture that fosters mutual accountability. Netflix is on track for strong revenue delivery; it has a strong twelve month stock performance and consistent revenue growth. The seven aspects of its culture are:

- 1) Values are what we value
- 2) High performance
- 3) Freedom and responsibility
- 4) Context, not control
- 5) Highly aligned, loosely coupled
- 6) Pay top of market
- 7) Promotions and development.

Under the Freedom and Responsibility section of its company policies, Netflix contradicts corporate tendencies because it works to increase employee freedom rather than limit it. In creating such a work environment the employer is able to attract creative and innovative people and reap the rewards with sustainable business results. Netflix points out that with the right people, the emphasis is less on new processes and more on the quality of talent pool. Netflix has two rules: prevent irrecoverable disaster and adhere to moral, ethical and legal issues. Netflix expects to hire the best, compensate accordingly and get results. It trusts that staff will use the same level of judgement and act in its best interest. Some highlights for Netflix include:

- The best managers figure out how to get the best from people by establishing context, not controlling the people or outcomes.
- When employees fail, managers should start by asking themselves what they could have done better to set the right context, insight and guidance.
- “Highly aligned, loosely coupled” means group interactions are focused on strategy and goals. Groups will move faster to tactical development and execution in a climate of trust (to get the work done) vs. Audit.
- Pay accordingly. Their “goal is to keep each employee at the top of market for that person”.

- It is okay for employees to test the job market and validate their worth-with the caveat that you talk to your manager about what you find so a salary discussion is transparent, honest and fact based.
- You can move from “the minors to the majors” but you have to be a superstar. Opportunity, the competing pool of superstars and timing will play a role in advancement.
- Personal develop is a personal responsibility not a corporate responsibility.

What makes Netflix unique is the practical application of its culture-starting at the top and reinforced throughout the company. It is based on reciprocity and respect for strong individual talent and results. Yes, its compensation strategy fits its business strategy, organizational culture and external pressures. Compensation would not change because Netflix pays the market rate, wants to pay the best to attract and retain an excellent talent pool. Refer to the Netflix website: <https://www.netflix.com> for more information on its movies/TV series rental industry and some of the external pressures/challenges it faces.