

15.660

**Strategic Human Resource
Management**



**Professor M. Diane Burton
MIT Sloan School of Management**

The Functions of Pay



✦ External

- ✦ allocate across firms and occupations

✦ Internal

- ✦ attract and maintain labor forces
- ✦ allocate across occupations
- ✦ motivate and align behavior
- ✦ provide status
- ✦ provide sense of equity

Key Market Ideas



- ✦ Reservation wage
- ✦ Compensating differentials
- ✦ Meaning of equilibrium
- ✦ Elasticity of demand curve

Why Market Model is Incomplete



- ✦ Adjustment is long and slow
 - ✦ imperfect information
 - ✦ barriers to mobility
 - ✦ social / institutional rigidity
- ✦ Role of Power
 - ✦ monopoly rents
 - ✦ unions
 - ✦ licensing
- ✦ Discrimination

Elements of Pay System



- ✦ Level relative to market
- ✦ Basis for pay
- ✦ Composition of pay package

Level of Pay



- ❖ Expected value over lifetime
- ❖ Influences ability to recruit and turnover
- ❖ Firms position selves differently relative to market

THE IMPACT OF PAY DISPERSION, BASEBALL



1644 players, 1985-93

measures: batting performance, fielding performance, pitching performance, team performance

explanatory variables: team pay dispersion, player rank in team pay hierarchy

Controls: past performance, age, years in league, measure of team talent

BASEBALL (con't)



1. Greater team dispersion reduces individual performance on average
 - those at top of hierarchy perform better if team pay dispersed, those at bottom perform worse
2. Overall team performance reduced by greater pay dispersion

BASIS FOR PAY



- ✦ Internal Consistency
 - Job Analysis/Point System
 - Equity Issues
- ✦ External Competitiveness
 - Surveys
- ✦ Employee Characteristics
 - Seniority/Need/Performance

Composition of Pay Package



- ✦ Benefits relative to wages
 - ✦ impact upon composition of labor force
 - ✦ impact upon turnover
 - ✦ impact upon commitment

BENEFITS



Percent of Compensation, 1997, Private Sector Establishments

1-99 employees	24.9%
100-499	27.6%
500+	30.8%

Source: Bureau of Labor Statistics

Pay for Performance



- ❖ To what unit is it applied?
 - ❖ where the link between action and performance is closest
 - ❖ individual (but leads to non-cooperation)
 - ❖ group (but problems of free-riding)
 - ❖ organization (free-riding plus impact of my actions are hard to see)

Pay for Performance



- ✦ Long-run or short-run measures
 - ✦ short-run creates perverse incentives
 - ✦ run from your mistakes
 - ✦ actions such as skimping R&D
 - ✦ long-run may be too far out to motivate

Pay for Performance



- ❖ How to control for external forces?
 - ❖ tournament model
 - ❖ forced distribution

- ❖ But
 - ❖ impact on cooperation
 - ❖ impact on fairness morale

Pay for Performance



- ❖ How much dispersion do you permit?
- ❖ As risk rises need to compensate by increasing level
- ❖ Need to be prepared to share information on which performance is judged
- ❖ Proper mixes of different schemes

PAY SCHEMES



- ✦ BONUSES/PROFIT SHARING
- ✦ PAY FOR SKILL
- ✦ GAIN-SHARING

BONUS/PROFIT SHARING



GOALS: IMPROVE INCENTIVES
AVOID INCREASING BASE
(control benefits)

ISSUES: ARE INCENTIVES STRONG?
FREE-RIDING
FAIRNESS/USE OF
DISCRETION

PAY FOR SKILL



**GOALS: PROVIDE INCENTIVES FOR
SKILL ACQUISITION**

**ISSUES: TOPPING OUT
PAY NOT RELATED TO
ORGANIZATIONAL
PERFORMANCE**

GAINSHARING



EXAMPLES: SCANLON, RUCKER,
IMPROSHARE

PROCEDURE: ESTABLISH A BASELINE
FOR A WORKGROUP;
REWARD IF EXCEED,
REDUCE PAY IF FALL
BELOW

GAINSHARING (con't)



ISSUES: METRIC USED (e.g. a mixture of productivity, quality, profits)

**ROLE OF TECHNICAL
CHANGE, LUCK**

**DEGREE OF INFORMATION
SHARING**

Case Discussion



SAS Institute

The SAS Institute



- ❖ Founded in 1976, SAS Institute is now the 9th largest independent software company in the world, with revenues of \$1.1 billion and 8,500 employees.
- ❖ It has achieved this with:
 - No long-term planning
 - No formal product strategy
 - No stock options
 - No performance appraisal
 - Free on-site health care
 - An artist-in-residence

The SAS Institute



“In an era of relentless pressure, this place is an oasis of calm. In an age of frenetic competition, this place is methodical and clearheaded. In a world of free agency, signing bonuses, and stock options, this is a place where loyalty matters more than money.”

**Charles Fishman
Fast Company,
January, 1999**

SAS versus Other Software Houses



- ❖ Based on your experience, what's different about how SAS manages people and projects, compared to other software firms?
- ❖ What differences in assumptions does this reflect?

The SAS Institute



“If you’re hiring creative people, you give them their head, you tell them that it’s all right to take chances and you mean it, [and] they will do their best.”

David Russo
VP of HR, SAS

Why doesn't this lead to chaos?

Another impediment?



You may not share Goodnight's values and assumptions.

If you don't believe this can work, you can't fake it.

Decisions about Compensation Systems



- ❖ How much emphasis to place on pay?
- ❖ Level of base pay?
- ❖ What's included in the pay package (benefits, promotion, ownership)?
- ❖ Degree of pay dispersion?
 - ❖ Across levels
 - ❖ Across departments
 - ❖ Across individuals within departments and levels
- ❖ Basis for pay (Individual, group, organization)?
- ❖ Basis for measurement (tenure, skills, outcomes, etc.)?

Some Myths About Incentives

- “People work primarily for financial rewards.”
- “Other people are more motivated by incentives than I am.”
- “Individual monetary incentives are critical to motivate hard work and attract the right folks.”
- “The financial and legal aspects of ‘ownership’ are what align interests and motivate.”
- “Labor rates \equiv labor costs”
 - ✦ It’s not what you pay but what you get that matters

Implications



- ❖ Be careful and thoughtful about the attributions you make regarding other people's motivations
- ❖ Assuming that "agents" are driven by pay and need to be "controlled" can become a self-fulfilling prophecy
- ❖ It's very hard to "fake it," so be clear about your own motivational assumptions before you begin designing control systems.