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A Two-component Approach to Compensation

By decreasing base-salary increases and adding lump-sum bonuses, companies can overcome budget and program limitations to link employee pay to performance better.

Each year, companies develop salary-increase budgets and try to distribute these budgeted funds equitably, based on individual performance. Human resources professionals try to support this process by developing increase guidelines and objective-performance measures. But just as everyone has difficulty deviating from a 15% gratuity at a restaurant, so do managers have a difficult time deviating from their preset budgets.

There are several reasons for companies' inability to pay for performance. The most common include:

1) *The base-salary-increase mechanism is trying to recognize too much*. For most workers, base-salary increases are their only recognition-and-reward vehicle. The size of an employee's base-salary increase may depend on company performance, unit performance, personal development, achievement of financial and operational objectives or taking on new responsibilities. This wide array of factors makes it difficult for managers to decide on a specific increase number and to describe how each factor contributes to that number.

2) *The small salary-increase budgets aren't motivational*. According to the American Compensation Association, salary-increase budgets have been between 5% and 5.4% since 1987. This amount isn't enough to serve as a powerful motivator for the general employee population.

3) *Salary-increase budgets barely top the cost of living*. Recently, annual salary-increase budgets barely have exceeded the change in the CPI-U (the consumer-price index for all urban areas, the primary determinant of cost-of-living adjustments). According to the Bureau of Labor Statistics and American Compensation Association, the difference between salary increases and the change in the CPI has been 0% to 1.4% during the past five years. Employees, right or wrong, feel entitled to a cost-of-living adjustment. Therefore, only the negligible difference between the CPI and salary increases is viewed as the true merit budget.

Use base-salary increases to reward achievements that make employees more valuable; use lump-sum bonuses to reward other accomplishments.

Salary increases and bonuses can link pay to performance. In general, companies have viewed lump-sum bonuses as an alternative to annual salary increases. However, there's nothing to prevent companies from using both base-salary increases *and* lump-sum bonuses to deliver pay to all employees.

Using a two-component program provides managers with two reward vehicles:

- A lump-sum bonus to recognize annual achievements
- A base-salary increase to recognize lasting contributions to the company.

To determine which of the two reward vehicles to use, tie the term of the reward to the term of the accomplishment. If an accomplishment affects the employee's expected contribution positively, view it as long-term, and reward the employee with a base-salary increase. The manager should reward most other accomplishments with a lump-sum bonus. Each organization will have its own business priorities and subsequent performance objectives.

To apply the two-component program, human resources professionals can group events or accomplishments into six categories, listed here with suggestions for applying rewards:

1) *Annual financial or operational results*: This includes accomplishments that relate to annual profitability, production, sales, return on investment and so on. Managers can recognize these accomplishments best with a lump-sum bonus. Financial success in one year won't guarantee success in the next year. Therefore, the company shouldn't reward the employee with guaranteed salary.

2) *Special projects*: A special one-

time project that has a predetermined time frame will add activity and responsibility to a job for a temporary period. During this period, the manager should reward the employees with lump-sum bonuses that take into consideration special-project performance.

3) *Productivity or quality improvements*: Managers should reward with a lump-sum bonus those improvements that are the result of a suggestion or a specific effort. Some productivity or quality improvements may be the result of additional skills or responsibilities, which are discussed below.

4) *Additional skills*: At times, employees acquire new skills or competencies that make them more efficient or better able to perform their job responsibilities. When this happens, managers should reward the individuals with base-salary increases that are consistent with the incremental contribution of these new skills or competencies.

5) *Additional responsibilities*: Managers should reward with a base-salary increase new responsibilities that augment the employee's expected contribution to the company.

6) *Promotions*: Managers should reward with a base-salary increase an employee's promotion to a new job that has a higher level of expected contribution. This increase should reflect the magnitude of change in the employee's responsibilities.

Pay for performance drives the two-component program. Organizations that introduce lump-sum bonuses often alienate their employees who are accustomed to base-salary increases. In introducing lump-sum programs, companies make three critical mistakes:

1) Introducing lump-sum bonuses as a replacement for base-salary increases, not as a complement to such a program

2) Not communicating a rationale for lump-sum bonuses other than the evident cost savings

3) Failing to develop a lump-sum-bonus pool that's large enough to distract employees from any perceived base-salary take away.

The driving force behind the two-component program is pay for performance, not cost savings (see "Pay-delivery Alternatives"). This chart compares the compensation of an employee during a 10-year period using base-pay-only with compensation under a two-component pay-delivery program. With the traditional program, the employee receives a 5% base-salary increase every year. At the end of 10 years, the employee has earned $440,227. Under the two-component program, the employee receives a 3.5% base-salary increase plus a 7.2% lump-sum bonus each year. At the end of 10 years, the employee has earned $440,162.

This chart offers a break-even example for one employee. The same logic applies to the entire employee population. A company's payroll for a 10-year period (given a stable work force) would be about the same whether it budgeted a 5% annual-salary-increase pool or a 3.5% salary-increase pool and a 7.2% lump-sum bonus pool.

The organization's total pay expenditure is approximately the same for both programs. With the two-component program, however, managers have a salary-increase pool they can use to recognize employee development and long-term accomplishment, and a huge lump-sum-bonus pool for recognizing employees' annual performance.

The smaller salary-increase budget is justified because salary increases no longer will be the only vehicle to use to reward all types of performance. Salary increases only reward increased job responsibility, increased competency and long-term contributions. Salary increases also could relate to changes in the cost of living, although at some point employees must understand that wages should be driving living costs, not the reverse.

Two-component systems require changes in other areas. The successful administration of the two-component program depends heavily on proper modifications to: 1) the performance-management process, and 2) the pay-delivery guidelines.

1) *The performance-management pro-*

Pay-delivery Alternatives

	TRADITIONAL PROGRAM			TWO-COMPONENT PROGRAM			
Year	Base salary	Annual increase	Total earnings	Base salary	Annual increase	Lump-sum bonus	Total earnings
1993	$35,000	5.0%	$35,000	$35,000	3.5%	7.2%	$37,520
1994	$36,750	5.0%	$36,750	$36,225	3.5%	7.2%	$38,833
1995	$38,588	5.0%	$38,588	$37,493	3.5%	7.2%	$40,192
1996	$40,517	5.0%	$40,517	$38,805	3.5%	7.2%	$41,599
1997	$42,543	5.0%	$42,543	$40,163	3.5%	7.2%	$43,055
1998	$44,670	5.0%	$44,670	$41,569	3.5%	7.2%	$44,562
1999	$46,903	5.0%	$46,903	$43,024	3.5%	7.2%	$46,122
2000	$49,249	5.0%	$49,249	$44,530	3.5%	7.2%	$47,736
2001	$51,711	5.0%	$51,711	$46,888	3.5%	7.2%	$49,407
2002	$54,296		$54,296	$47,701		7.2%	$51,136
10-year earnings			**$440,227**	**10-year earnings**			**$440,1**

Source: Howard Johnson & Co.

cess. The performance-review process at most organizations focuses on three areas:

- Performance traits or behaviors, such as teamwork, communication skills, quality of work, initiative and so on
- Annual goal setting and review
- Employee development.

The first two areas usually form the basis for the amount of the salary increase. Employee development offers some intrinsic value and may play into promotion decisions, but is unlikely to be linked directly to any pay decision.

Under the two-component program, base-salary increases will be tied directly to employee development. This should cause employees to take a greater interest in improving their contribution levels. It also will place more pressure on the company to identify and certify skills and abilities that lead to increased productivity and higher quality from employees.

Rewards for annual contribution and accomplishment potentially can be large (7% to 15% of base pay). Therefore, companies need to make certain that employees are focused on the correct areas of accomplishment. Companies need to remove employees' performance blinders by getting them involved in defining objectives and providing them with some latitude in achieving those objectives. Employees will need to take responsibility for developing ideas that will contribute to cost reduction, higher productivity and improved quality, having the assurance that management will reward their efforts satisfactorily. HR professionals need to make sure that the company's performance-management systems examine such factors as the specific actions that the employee takes that contribute to profitability, quality improvements and customer service.

The two-component program will transform the current performance-management process into a discussion of how the employee has contributed to the organization in the past year, and how and why the employee will contribute at a higher level during the next year.

2) *Pay-delivery guidelines.* Companies usually require guidelines to ensure that the allocation of incremental pay is equitable and that there's some degree of control over total pay expenditures. Companies typically allocate increases based on performance level or on performance level and position in salary range. The concept behind these pay guidelines doesn't change with the two-component program. There are, however, two sets of allocation guidelines—one each for base-salary increases and lump-sum bonuses.

The amount of the base-salary increase will focus on how the skill and responsibility levels of the employee have changed during the past year and how that change influences that person's expected contribution. For example, if the company expects the employee to contribute at a *much higher level*, the employee will receive an 8% base-salary increase. If the company expects the employee to contribute at a *slightly higher level*, the base-salary increase will be 3.5%. Employees expected to contribute at the *same level* will receive no base-salary increase. These actions are consistent with the way the market rewards companies for expected performance (through stock price gains).

For many employees, the level of expected contribution doesn't change every year. Managers will deliver rewards to these employees primarily through lump-sum bonuses. The lump-sum bonus focuses on the annual contributions of the employee—how the employee contributes to the achievement of organizational goals related to sales, profit, quality, safety, production and so on; how the employee performs on special projects; and generally, how diligent and smart the employee is in performing the work.

For example, an employee whose level of annual contribution is *outstanding* might receive a lump-sum bonus that's 15% of his or her base pay. A *commendable* contribution might warrant 10% of base pay; *satisfactory,* 7.5%; *marginal,* 3.5%; and *unsatisfactory,* 0%.

How does two-component pay delivery work? At the beginning of the year, expectations for the contribution of two sales representatives (Sales Rep A and Sales Rep B) are the same. The company expects both to sell $800,000 of Product #7 and keep travel expenses down to the same level as last year.

At year's end, Sales Rep A has sold only $600,000 of Product #7, and annual travel expenses have increased by 5%. During the year, however, Sales Rep A has developed the ability to sell Product #8 and Product #9, and has become responsible for supervising a junior sales

The Advantages of a Two-component Approach to Compensation

The two-component approach to delivering pay combines lump-sum bonuses, which recognize annual achievements, with base-salary increases, which recognize lasting contributions to the company. Such an approach to compensation offers the following powerful business advantages to companies:

1) Reducing fixed payroll expenses. Lowering base-salary increases will reduce the fixed-expense portion of total pay. This will make companies better able to tie total pay levels to their ability to pay. In a profitable year, companies can fund large lump-sum pools. In lean years they can fund smaller pools. These actions can be taken without fear of the long-range business consequences that variant salary-increase pools can cause.

2) Reducing benefit costs. Many benefits are tied to the base-salary levels of employees (life insurance, disability, retirement and so on). To the extent that base-salary levels are reduced, these benefit costs also are reduced. (Companies can choose to offset the benefit reduction to employees by modifying the basis for benefits or offering larger lump-sum bonus pools.)

3) Supporting employee-development initiatives. Under the two-component pay program, the primary use of base-salary increases will be to reward employee development.

4) Providing annual motivational rewards. To the extent that companies reduce base-salary increases, they can fund whopping lump-sum bonus pools that will capture the attention of even the most apathetic employee. —*RBH* representative for Product #8. How should the firm deliver incremental pay?

Sales Rep A has done little to contribute to the current annual results of the organization, so a 0% (unsatisfactory) lump-sum bonus might be appropriate. However, Sales Rep A has acquired skills and responsibilities that will benefit the organization in the future. Therefore, the company rewards Sales Rep A with an 8% base-salary increase, which communicates the company's expectation of a *much higher level* of contribution.

At year's end, Sales Rep B has sold $1.1 million of Product #7 and reduced annual travel expenses by 5%. The company rewards Sales Rep B with a 15% lump-sum bonus for an *outstanding* level of annual contribution. Because the employee has acquired no additional skills or responsibilities, the company's expectations for the employee remain unchanged for the next year. Therefore, Sales Rep B will receive no base-salary increase.

In this example, nothing that Sales Rep B did to reach the $1.1 million sales level has given the company the confidence to expect the same high level of performance next year. If the company believes that Sales Rep B can produce $1.1 million next year and therefore revises the sales goal upward, then it also increases the base-salary level.

If base-salary increases alone haven't been powerful enough to motivate top management, how can human resources professionals expect these increases to motivate rank-and-file employees? Companies can attribute the failure of pay for performance partially to tying all of an employee's annual activities and accomplishments to a modest reward somewhere between 4% and 6%.

Companies currently possess the financial means and the salary-management tools to implement a two-component approach to delivering pay. This approach supports the fundamental concepts underlying skill-based pay, broadbanding and self-managed work teams, yet it can succeed in delivering powerful annual compensation in the traditional pay-delivery environment. ■

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