

## **Lecture 2: Introduction to Compensations and Wages**

### **Learning Objectives**

- To understand the concept of compensation.
- To understand Methods of Compensation
- To know the concept of Wage Level and Wage Rate.

### **1. The Definition of Compensation**

Compensation refers to a wide range of financial and non financial rewards to employees for their services rendered to the organization.

### **2. Types of Compensation**

Total compensation returns are more transactional. They include pay received directly as cash (like base, merit, incentives, cost of living adjustments) and indirectly as benefits (like medical insurance, social services):

#### **a. Direct Compensation components**

Direct compensation refers to monetary benefits offered and provided to employees in return of the services they provide to the organization. Whereby the employer provides monetary rewards for work done and performance results achieved. The monetary benefits include basic salary, house rent allowance, conveyance, leave travel allowance, medical reimbursements, special allowances, bonus, etc. They are given at a regular interval at a definite time.

#### ✓ **Basic Salary**

Salary is the money an employee receives from his/her employer by rendering his/her services.

#### ✓ **Various work allowances**

It is allowances vary according to the type of job.

#### ✓ **House Rent Allowance**

Organizations either provide accommodations to its employees who are from different state or country or they provide house rent allowances to its employees. This is done to provide them social security and motivate them to work.

#### ✓ **Conveyance**

Organizations provide for cab facilities to their employees. Few organizations also provide vehicles and petrol allowances to their employees to motivate them.

#### ✓ **Family grants**

A cash grant for the partner and/or children. It is related to the family status of the worker.

#### ✓ **Bonus**

Bonus is paid to the employees during festive seasons to motivate them and provide them the social security.

#### ✓ **Special Allowance**

Special allowance such as overtime, mobile allowances, meals, travel expenses, etc are provided to employees to provide them social security and motivate them which improve the organizational productivity.



### Direct Compensation

#### b. Indirect Compensation components

Indirect compensation refers to non-monetary benefits offered and provided to employees in lieu of the services provided by them to the organization. Indirect compensation given to an employee or group of employees as part of membership in the organization. They include Leave Policy, Overtime Policy, Hospitalization, Insurance, Leave travel Assistance Limits, Retirement Benefits, Holiday Homes.

##### ✓ Leave Policy

It is the right of employee to get adequate number of leave while working with the organization. The organizations provide for paid leaves such as, casual leaves, medical leaves (sick leave), and maternity leaves, statutory pay, etc.

##### ✓ Overtime Policy

Employees should be provided with the adequate allowances and facilities during their overtime, if they happened to do so, such as transport facilities, overtime pay, etc.

##### ✓ Hospitalization and medical Reimbursement

Organizations also look after the health conditions of their employees. The employees are provided with medi-claims for them and their family members. These medi-claims include health-insurances and treatment bills reimbursements. Also the employees should be provided allowances to get their regular check-ups, say at an interval of one year.

##### ✓ Insurance

Organizations also provide for accidental insurance and life insurance for employees. This gives them the emotional security and they feel themselves valued in the organization.

##### ✓ Leave Travel

The employees are provided with leaves and travel allowances to go for holiday with their families. Some organizations arrange for a tour for the employees of the organization. This is usually done to make the employees stress free.

##### ✓ Retirement Benefits

Organizations provide for pension plans and other benefits for their employees which benefits them after they retire from the organization at the prescribed age.

✓ **Holiday Homes**

Organizations provide for holiday homes and guest house for their employees at different locations. These holiday homes are usually located in hill station and other most wanted holiday spots. The organizations make sure that the employees do not face any kind of difficulties during their stay in the guest house.

✓ **Flexible Timings**

Organizations provide for flexible timings to the employees who cannot come to work during normal shifts due to their personal problems and valid reasons.



**Indirect Compensation**

Also the compensation can be classified into:

a. **Base Pay**

The basic compensation that an employee receives, usually as a wage or a salary, is called **base pay**. Many organizations use two base pay categories, *hourly* and *salaried*, which are identified according to the way pay is distributed and the nature of the jobs. Hourly pay is the most common means and is based on time.

Employees paid hourly receive **wages**, which are payments calculated based on time worked. In contrast, people paid **salaries** receive the same payment each period regardless of the number of hours worked.

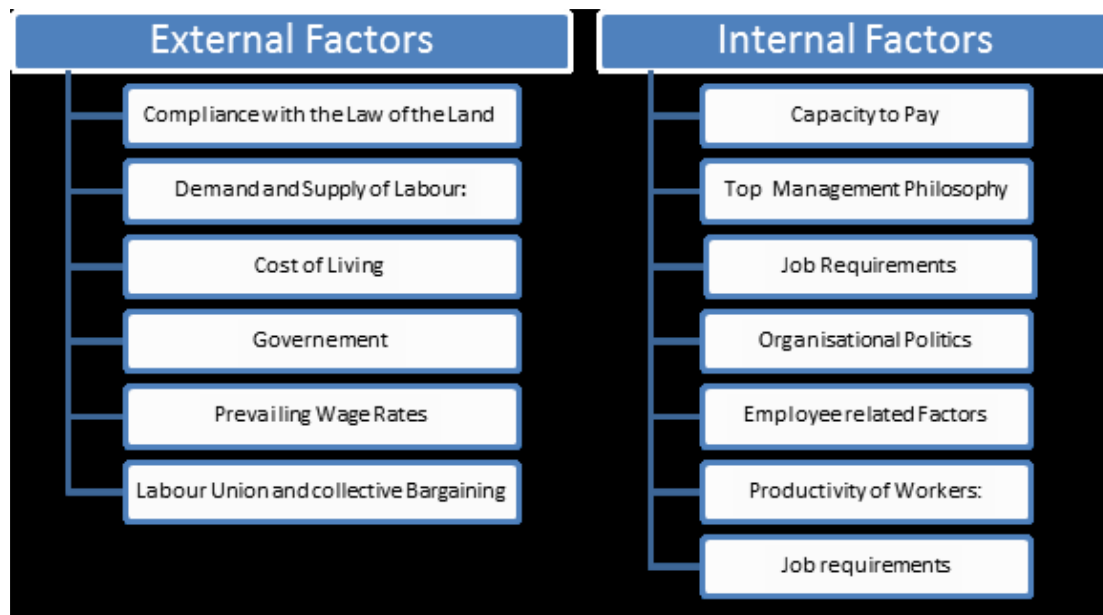
b. **Variable Pay**

Another type of direct pay is **variable pay**, which is compensation linked directly to individual, team, or organizational performance. The most common types of variable pay for most employees are bonuses and incentive program payments.

c. **Benefits**

Many organizations provide rewards in an indirect manner. With indirect compensation, employees receive the tangible value of the rewards without receiving actual cash. A **benefit** is a reward—for instance, health insurance, vacation pay, or a retirement pension—given to an employee or a group of employees for organizational membership, regardless of performance.

**3. Factors Considered in Deciding the Compensation**



### a. External Factors

#### ✓ Demand and Supply of Labour

Wage is a price or compensation for the services rendered by a worker. The firm requires these services, and it must pay a price that will bring forth the supply which is controlled by the individual worker or by a group of workers acting together through their unions.

#### ✓ Cost of Living

This tends to vary money wage depending upon the variations in the cost of living index following rise or fall in the general price level and consumer price index.

#### ✓ Labour Union

Organized labor is able to ensure better wages than the unorganized one. Higher wages may have to be paid by the firm to its workers under the pressure or trade union.

#### ✓ Government

To protect the working class from the exploitations of powerful employers, the government has enacted several laws. Laws on minimum wages, hours of work, equal pay for equal work, payment of dearness and other allowances, payment of bonus, etc., have been enacted and enforced to bring about a measure of fairness in compensating the working class.

#### ✓ Prevailing Wage Rates

Wages in a firm are influenced by the general wage level or the wages paid for similar occupations in the industry, region and the economy as a whole. External alignment of wages is essential because if wages paid by a firm are lower than those paid by other firms, the firm will not be able to attract and retain efficient employees.

### b. Internal Factors

#### ✓ Ability to Pay

Employer's ability to pay is an important factor affecting wages not only for the individual firm, but also for the entire industry. This depends upon the financial position and profitability of the firm.

#### ✓ Top Management Philosophy

Wage rates to be paid to the employees are also affected by the top management's philosophy, values and attitudes. As wage and salary payments constitute a major

portion of costs and /or apportionment of profits to the employees, top management may like to keep it to the minimum.

✓ **Productivity of Workers**

To achieve the best results from the workers and to motivate him to increase his efficiency, wages have to be productivity based. There has been a trend towards gearing wage increase to productivity increases. High wages and low costs are possible only when productivity increases appreciably.

✓ **Job Requirements**

Job requirements indicating measures of job difficulty provide a basis for determining the relative value of one job against another in an enterprise. Explicitly, job may be graded in terms of a relative degree of skill, effort and responsibility needed and the adversity of working conditions. The occupational wage differentials in terms of

- a) Hardship,
- b) Difficulty of learning the job
- c) Stability of employment
- d) Job Responsibility and
- e) Change for success or failure in the work.

✓ **Employees Related Factors**

- i) Performance: productivity is always rewarded with a pay increase. Rewarding performance motivates the employees to do better in future.
- ii) Seniority: seniority is the most objective criteria for pay increases.
- iii) Experience: Makes an employee gain valuable insights and is generally rewarded
- iv) Potential: organizations do pay some employees based on their potential. Young managers are paid more because of their potential to perform even if they are short of experience.

✓ **Organizational Politics**

- i) Determination of firms included in the compensation survey: managers could make their firm appear to be a wage leader by including in the survey those organizations that are pay followers.
- ii) Choice of compensable factors for the job evaluation plan: Again, the job value determined by this process could be manipulated
- iii) Emphasis placed on either internal or external equity and
- iv) Results of employee performance appraisal may be intentionally distorted by the supervisor

#### **4. Objectives of Compensation Management**

##### **1.To Establish a Fair and Equitable Remuneration**

Effective compensation management objectives are to maintain internal and external equity in remuneration paid to employees. Internal equity means similar pay for similar work.

##### **2.To Attract Competent Personnel**

A sound wage and salary administration helps to attract qualified and hard- working people by ensuring an adequate payment for all jobs.

##### **3.To Retain the Present Employees**

By paying competitive levels, the company can retain its personnel. It can minimize the incidence of quitting and increase employee loyalty.

##### **4.To Improve Productivity**

Sound wage and salary administration helps to improve the motivation and morale of employees which in turn lead to higher productivity

##### **5.To Control Cost**

Through sound compensation management, administration and labour costs can be kept in line with the ability of the company to pay. It facilitates administration and control of pay roll. The companies can systematically plan and control labour costs.

**6.To Improve Union Management Relations**

Compensation management based on jobs and prevailing pay levels are more acceptable to trade unions. Therefore, sound wage and salary administration simplifies collective bargaining and negotiations over pay.

**7.To Improve Public Image of the Company**

Wage and salary program also seeks to project the image of the progressive employer and to company with legal requirements relating to wages and salaries.

**8.To Improve Job Satisfaction**

If employees would be happy with their jobs and would love to work for the company they get fair rewards in exchange of their services.

**9.To Motivate Employees**

Employees Some of them want money so they work for the company which gives them higher pay. Some of them value achievement more than money, they would associate themselves with firms which offer greater chances of promotion, learning and development.

**10.Peace of Mind**

Offering of several types of insurances to workers relieves them from certain fears; as a result workers now work with relaxed mind.

**11.Increases Self-Confidence**

Every human being wants his/her efforts to get acknowledgment. Employees gain more and more confidence in them and in their abilities if they receive just rewards.

**5. Compensation Approaches**

Compensation is a systematic approach to providing monetary value to employees in exchange for work performed.

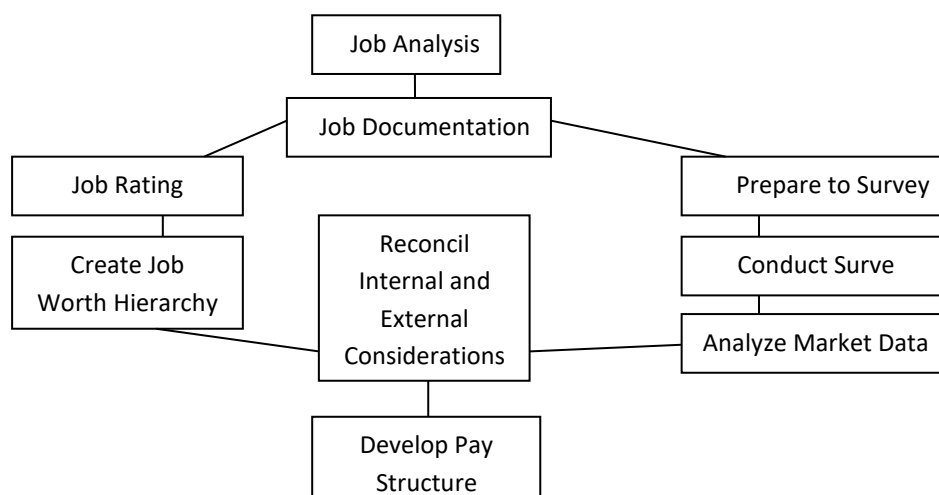
There are three different main goals of compensation app,

**a. Traditional Compensation Approach**

The traditional approach to the design of compensation package involves four basic components: the basic pay, some mechanism of compensation for loss of purchasing power of money, incentive for putting effort beyond the norm and fringe benefits.

For some organizations, a traditional compensation approach makes sense and offers certain advantages in specific competitive situations. It may be more legally defensible, less complex, and viewed as more “fair” by average and below average employees. It reflects a logical, rational approach to compensating employees.

*The Traditional Approach to Compensation*



**b. Total Rewards Approach**

It tries to place a value on individual rather than just the jobs. Widespread use of various incentive plans, team bonuses, organizational gain sharing programs, and other designs serves to link growth in compensation to results.

**Differences between Traditional Compensation Approach and Total Rewards Approach**

<b>Traditional Compensation Approach</b>	<b>Total Rewards Approach</b>
➤ Compensation is primarily base pay	➤ Variables pay is added to base pay
➤ Bonuses/perks are for executives only	➤ Annual/long-term incentives are provided to all
➤ Fixed benefits are tied to long tenure	➤ Flexible and portable benefits are offered
➤ Pay grade progression is based on organizational promotion	➤ Knowledge/ skill-based broad band's determine pay grade
➤ Organizational wide standard pay plan exists	➤ Multiple plans, consider job family, location and business units

**c. 3 P's Approach to Compensation Management**

There are 3P approach of developing a compensation policy centered on the fundamentals of paying for Position, Person and Performance. Drawing from external market information and internal policies, this approaches helps to establish guidelines for an equitable grading structure, determine capability requirements and creation of short and long-term incentive plans. The 3P approach to compensation management supports a company's strategy, mission and objectives. It is highly proactive and fully integrated into a company's management practices and business strategy. The 3P system ensures that human resources management plays a central role in management decision making and the achievement of business goals.

- Paying for position
- Paying for person
- Paying for performance or pay-for-performance philosophy requires that compensation changes reflect performance differences. Organizations operating under this philosophy do not guarantee additional or increased compensation simply for completing another year of organizational service. Instead, they structure pay and incentives to reflect performance differences among employees. Employees who perform satisfactorily maintain or advance their compensation levels more than marginal performers. The bonuses and incentives are based on individual, group, and/or organizational performance.

Because it is so important to employees, the issue of pay deserves to be clearly addressed. In spite of their hesitance, managers are capable of dealing with this sometimes difficult issue in a professional and effective manner. By keeping the following basic points about pay in mind, they can address virtually any pay-related topic with the employees in a professional and productive manner.

**Specificity is Key**

Pay is a topic with many different shades and a variety of implications. Whenever approaching the subject, it is important to work out the details beforehand so that specifics can be clearly communicated. For the manager, this means that the increase amount is nailed down before discussing a promotion with an employee. No chance of misunderstanding or false expectations can be permitted. Far too often, managers are apt to discuss generalities.

“It will mean a good increase.” What exactly does that mean in terms of the employee’s monthly budget? If care is not taken here, good news can become the source of conflict and resentment.

### **Pay is Relative**

What one employee considers a fantastic increase maybe an insult to another? Each individual has a unique set of creativity and competencies. Pay should be based on the performance, position and the competencies/skills the person is having.

### **Pay is Not Created Equal**

Various forms of pay have different purposes. The two most common forms of direct cash compensation in most companies are base pay and bonus. Base pay is the annual salary or hourly wage paid to an employee given the job he holds, While bonus is typically (or at least should be) rewarded based on the achievement of a goal of the organization. Discussions about bonus payments should be as specific as possible. This is the opportunity to point out particular accomplishments that contributed to overall team or company success. Even if the bonus is paid to all employees based on a simple overall company profit target, the manager should use the opportunity to point out specifically how individual employees helped achieve that target.

### **Pay Based on the Performance**

Even when performance is a factor, the manager is faced with the difficult task of evaluating an entire year’s worth of activity and then categorizing it according to the percentage increase options allowed by the budget. It becomes very difficult to pinpoint specific employee actions or accomplishments as the reason for the increase. For these reasons, it’s appropriate for the discussion about base pay increases to be more general and balanced. Both strengths and weaknesses of the employee should be addressed. The actual increase is then based on an overall assessment, as opposed to a link with one or two specific outcomes. Any other factors that impact the increase percent, such as budget or pay range should be openly discussed as well.

## **6. Wage level**

### **6.1.What is a Wage Level?**

The ‘wage levels’ represent the money an average worker makes in a geographic area or in his organization. It is only an average; specific markets or firms and individual wages can vary widely from the average.

### **6.2.What is a Wage Rate?**

A **wage** is an amount of money paid to a worker for some specified quantity of labor. When expressed with respect to time, it is typically called the wage rate.

The wage rate is the pre-tax amount of payment, usually monetary, paid per unit of labor. It is the main monetary item that the worker and the employer focus on.

### **6.3.Wage Differential**

A wage differential refers to the difference in wages between people with similar skills within differing localities or industries. It can also refer to the difference in wages between employees who have dissimilar skills within the same industry. It is generally referenced when discussing the given risk of a certain job. In other Words Wage differential is a term used in labor economics to analyze the relation between the wage rate and the unpleasantness, risk, or other undesirable attributes of a particular job. For example, if a certain line of work requires someone to work around hazardous chemicals, then that job may be due a higher wage when compared to other jobs in that industry that do not necessitate coming into contact with dangerous chemicals. There are also geographical wage differentials where people with the same job may be paid different amounts based on where exactly they live and the attractiveness of the area.



## **7. Wage and Salary Administration.**

### **7.1. Wage and salary administration definition**

It is a collection of practices and procedures used for planning and distributing company-wide compensation programs for employees. These practices include employees at all levels and are usually handled by the accounting department of a company.

### **7.2. Wage and Salary Administration – Nature**

1. The basic purpose of wage and salary administration is to establish and maintain an equitable wage and salary structure.
2. It is concerned with the establishment and maintenance of equitable labor cost structure i.e. an optimal balancing of conflicting personnel interest so that the satisfaction of the employees and employers is maximized and conflicts are minimized.
3. The wage and salary administration is concerned with the financial aspects of needs, motivation and rewards.
4. Employees should be paid according to the requirements of their jobs i.e. highly skilled jobs are paid more compensation than low skilled jobs.
5. To minimize the chances of favoritism.

### **7.3. Wage and Salary Administration – Objectives**

Its objectives are:

- i. To compare or draft company HR policy
- ii. Find out the income level and return ratio of similar industries
- iii. To understand wage differentiations
- iv. To examine the competitiveness of entry level employees
- v. To establish hiring rates favorable to the community
- vi. To keep abreast wage and salary rates with production cost
- vii. To minimize labor turnover due to pay disparity
- viii. To increase employee's satisfaction and morale
- ix. To learn about the trend of perks and benefits in the market
- x. To resolve existing labor problems concerning compensation.

## **8. Fringe Benefits**

### **8.1. Fringe Benefits means**

Fringe benefits are indirect form of compensation given to employees in addition to the various forms of cash pay- base pay, dearness allowance and incentive pay. They provide a quantifiable value for individual employees. They are the indirect form of compensation as they are not related to the performance but are granted to the employees for just being a member of the organization.

### **8.2. Reasons for Offering Fringe Benefits**

When a company wants to hire or keep an employee, they look at all the standard and non-standard compensation they can offer. The set of perks the business comes up with is known as a fringe benefits package. Creating one of these packages is challenging because even though the company wants to look like a good, competitive employment choice, they cannot make offers that put financial strain on the business. They must find a balance between meeting or exceeding market expectations and maintaining the company budget. Companies also know that employees will want benefits to increase over time, so they need to create a package that has room to grow. The following are the main reason company offers fringe benefits:



✓ **Social Security**

The employers must pay in whole or in part for certain legally mandated benefits and insurance coverage also known as social security. Social security refers to the protection which society provides for its members through a series of public measures against the economic and social distress that otherwise would be caused by the stoppage or substantial reduction of earnings resulting from sickness, maternity, employment injury, unemployment invalidity, old age and health.

✓ **Paternalistic or Humanistic Consideration**

Historically, fringe benefits were introduced with humanistic considerations to support wage compensation with certain infrastructure or facilities to provide for health, education and housing as also social, cultural, religious and recreational activities.

✓ **Tax Considerations**

There are individual and organizations to develop ingenious methods of avoiding the obligations through restructuring the pay packet. The various fringe benefits like house rent, education expenses, travel charges and many more are shown as reimbursement of expenditures. However, in recent years the tax authorities are taking exception to such camouflaging and disallowing non-wage benefits beyond certain limits.

✓ **Utilization of Leisure Time**

There is awareness about the effects of off-duty life style on working life and vice versa. The importance of leave and holidays for rest and recuperation is increasingly being understood. Keeping these in mind, organizations are providing various facilities for leave travel including expenses of travel maintenance of guest houses etc.

✓ **To Meet Price Rises**

Rising prices and cost of living has brought about incessant demand for provision of extra benefit to the employees. Employers too have found that fringe benefits present attractive areas of negotiation when large wage and salary increases are not feasible.

✓ **To Attract and Retain Best Talents**

As organizations have developed more elaborate fringe benefits programs for their employees, greater pressure has been placed upon competing organizations to match these benefits in order to attract and keep employees. Recognition that fringe benefits are nontaxable rewards has been major stimulus to their expansion.

✓ **To Protect Employees from Adverse Impact**

Rapid industrialization, increasingly heavy urbanization and the growth of a capitalistic economy have made it difficult for most employees to protect themselves against the adverse impact of these developments. Since it was workers who are responsible for production, it was held that employers should accept responsibility for meeting some of the needs of their employees. As a result, some benefits-and-services programs were adopted by employers.

✓ **Due to Government Legislation**

The growing volume of labor legislation, particularly social security legislation, made it imperative for employers to share equally with their employees the cost of old age, survivor and disability benefits.

✓ **Collective Bargain by Trade Unions**

The growth and strength of trade unions has substantially influenced the growth of company benefits and services.

✓ **Labor Scarcity and Competition**

Labor scarcity and competition for qualified personnel has led to the initiation, evolution and implementation of a number of compensation plans. A variety of incentives and benefits are being offered like company housing liberal loan facilities, construction of schools or re-imbursment of education expenditure, membership in clubs/professional associations, sponsorship for training and conference abroad etc to attract and retain people based on the competitors companies in the field.

**9. CAFETERIA APPROACH**

In Cafeteria benefit plan the employees could spend their benefits, allowances on a choice of benefits options. The idea is to allow the employee to put together his/her own benefit package subject to two constraints-

1. The employer must carefully limit total cost for each total benefit package.
2. Each benefit plan must include certain non-optional items.

• **Advantages of Cafeteria approach**

1. Employees choose packages that best satisfy their unique needs.
2. Flexible benefits, help firms need the changing needs of a changing workforce.
3. Increased involvement of employees and families improves understanding of benefits.
4. Flexible plans make introduction of new benefits less costly. The new option is added merely as one among a wide variety of elements from which to choose.
5. Cost containment- the organization sets the dollar maximum. Employee chooses within the constraint.

• **Disadvantages of Cafeteria style**

1. Employees made bad choices and find themselves not covered for predictable emergencies.
2. Administrative burdens and expenses increase.
3. Adverse selection- employees pick only benefits they will use. The subsequent high benefit utilization increases its cost.

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