The Pay Mix Exercise

ABSTRACT

The pay mix exercise, targeted toward late undergraduate and graduate students studying compensation, focuses on the strategic use of pay to attract, retain, and motivate employees. Working in groups, students weigh the sorting and motivational effects of four unique pay mixes and align the pay mixes with various positions. Students learn that employees' preferences and expectations for the various components of a compensation package differ. In addition, they evaluate how each pay mix results in sorting and motivational effects that influence a firm's ability to attract and retain employees and align their behaviors with organizational objectives.

Keywords: Compensation, pay mix, sorting/motivational effects

Introduction

Compensation is a topic covered in undergraduate and graduate human resource management courses. In addition, undergraduate and graduate degree programs in Human Resource Management often include compensation as a required or elective course. This classroom exercise, targeted toward late undergraduate and graduate students studying compensation, examines the sorting and motivational effects of different pay mixes and how organizations select different pay mix components (base pay, short- and long-term incentives, and benefits) to attract, retain, and motivate employees. Faculty can facilitate the exercise with traditional and non-traditional students in online and face-to-face classes. I have used this exercise multiple times in undergraduate and graduate courses with success and have found that students engaged with the material and increased their understanding of key compensations concepts.

Theoretical Foundation/Teaching Implications

Pay mix is a critical dimension of an organization's compensation policy (Gerhart & Milkovich, 1990), along with pay level and pay structures. A firm's pay mix, or the combination of base pay, incentives, and benefits an employer offers its employees, has both sorting and motivational (or incentive) effects. The sorting effect refers to a pay mix's impact on employee attraction and retention. For example, paying above-market rates attracts more (and higher quality) candidates and helps retain employees (Cappelli & Cascio, 1991). In addition, benefits can be an effective tool for attracting and retaining employees. Finally, pay-for-performance (PFP) plans such as individual and group bonuses, profit sharing, and stock options influence who is drawn to the organization and whether an employee stays with an organization (Goldmanis & Ray, 2015). For example, some individuals favor organizations that offer a pay mix with a sizeable pay-for-performance component. In contrast, risk-averse individuals prefer compensation plans more heavily weighted with base pay (Cadsby et al., 2016). Thus, organizations need to understand the preferences of potential job applicants relative to base pay, incentive pay, and benefits and how these preferences may vary across desired segments of the labor market (Merriman et al., 2016).

The motivational effect, which is the effect pay, especially incentives, can have on employee motivation and behaviors, suggests that tying pay to higher performance levels will enhance employee motivation and, hence, employee performance (Park & Sturman, 2016). For example, when meeting performance goals can result in higher pay, employees demonstrate a willingness to work hard and develop the skills needed to meet those goals. The motivational effect of performance pay aligns with expectancy theory which suggests that employees will be motivated when there is a strong link between effort and performance and performance and valued rewards (Vroom, 1964). In other words, motivation results when the employee believes they can perform at a level that will lead to desired rewards. Relative to the motivational effect, the goal is to offer a proportion of variable pay (short and long-term incentives) sufficient to motivate employees to engage in desired behaviors.

To fully understand compensation strategy, students must recognize the sorting and motivational effects of base pay, incentives, and benefits and their combined effect on attraction, retention, and motivation. The Pay Mix Exercise in Appendix 1 helps students reflect on how the various components of a pay mix work together to influence the composition of a firm's workforce and the behaviors employees exhibit on the job. By considering illustrative examples of pay mixes for different positions that reflect the pay practices at privately held companies in the U.S., students gain an understanding of the sorting and motivational effects of different pay mixes and recognize the impact of compensation decisions on employee attraction, retention, and motivation.

Learning Objectives

Upon completing this exercise, students will demonstrate an understanding of the sorting and motivational effects of pay and recognize the impact of various pay mixes on employee attraction, retention, and motivation.

Exercise Overview

Faculty facilitating the exercise in class should anticipate allocating 60 – 75 minutes for the activity and debrief. Students prepare for the exercise by completing a reading on pay mixes and the sorting and motivational effect of pay. Typically, I cover the topic of pay mixes early in the semester in my compensation course and toward the end of the semester in my human resource management class when discussing compensation practices.

At the beginning of the class in which I facilitate the exercise, I briefly review the four components of a pay mix -- base pay, short-term incentives, long-term incentives, and benefits. Next, students move into groups consisting of three to four individuals. After distributing copies of the activity and reviewing the instructions, students consider the four pay mixes and begin discussing the sorting and motivational effects of the various pay mixes. After discussing the motivational and sorting effects, students reach an agreement on the type of job (hourly, sales, managerial, or executive) that would most likely be associated with one of the four pay mixes. Lastly, student groups report their decisions and rationale to the class, and I record their answers on a whiteboard.

During the debrief, I review the empirical literature on various pay components' sorting and motivational effects to address any misunderstandings. Next, I ask students to share their expectations and preferences for the different pay mixes. Finally, we conclude the exercise with a discussion of the implications of an organization's pay mixes, highlighting potential unintended consequences associated with each of the pay mixes.

Session Description

The timeline for this MOBTS session consists of the following: Introductions and Exercise Overview (~ 5 minutes), Group Discussions (~ 15 minutes), Reporting Group Decisions (~ 5 minutes), Debrief and Recommendation for Use (~ 5 minutes)

The session will begin with brief introductions and an overview of the exercise supported by PowerPoint slides. After distributing the activity, moving into groups, and assigning two of the four pay mixes to each group, participants will discuss the sorting and motivational effects of their assigned pay mixes and come to an agreement on the type of job (hourly, sales, managerial, or executive) most likely associated with each of their pay mixes. Next, groups will report their decisions and rationale. Finally, I will conclude with follow-up questions (e.g., What might be an unintentional consequence of using pay mix B?) and ask for feedback and recommendations on improving the exercise.

References

Cadsby, C. B., Song, F., & Tapon, F. (2016). The Impact of risk-aversion and stress on the incentive effect of performance-pay. *Experiments in Organizational Economics, 19*, 189-227. https://doi.org/10.1177/0091026018783003

Cappelli, P., & Cascio, W. F. (1991). Why some jobs command wage premiums: A test of career tournament and internal labor market hypotheses. *Academy of Management Journal*, *34*(4), 848-868.

Gerhart, B., & Milkovich, G. T. 1990. Organizational differences in managerial compensation and financial performance. Academy of Management Journal, 33: 663-691.

Goldmanis, M., & Ray, K. (2015). Sorting Effects of Performance Pay. *Management Science, 61*(2), 335-353.

Merriman, K. K., Turner, L. A., Galizzi, M., & HaynesBaratz, M. (2016). Pay mix policies as (dis) incentives in motivated job choice decisions. *Translational Issues in Psychological Science*, *2*(2), 184-191. https://doi.apa.org/doiLanding?doi=10.1037%2Ftps0000070

Park, S., & Sturman, M. C. (2016). Evaluating form and functionality of pay-for-performance plans: The relative incentive and sorting effects of merit pay, bonuses, and long-term incentives. *Human Resource Management, 55*(4), 697-719.

Vroom, V. H. (1964). *Work and motivation.* Wiley.

Appendix 1

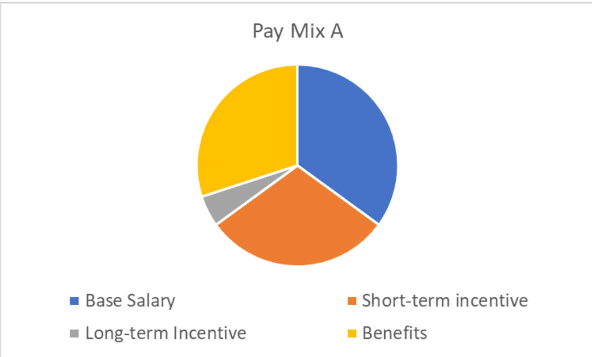
Pay Mix Exercise

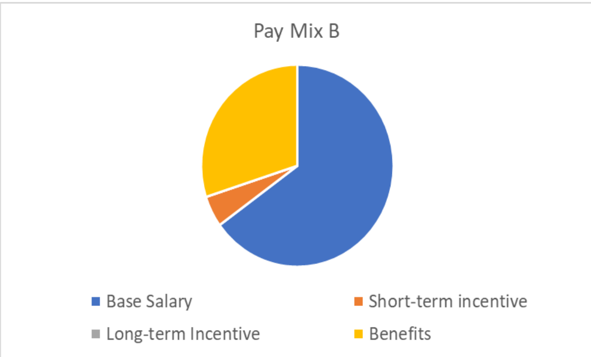
While there are many options when it comes to setting a pay mix, every combination can have a different impact on employee attraction, retention, and motivation. A Company's pay mix consists of the following four elements:

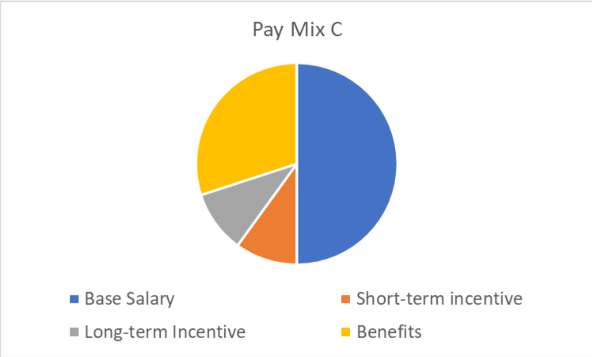
1. Base Pay — fixed payments based on an individual's role and responsibilities, experience, and expertise
2. Short-term Incentives — variable pay based on the attainment of short-term (I year or less) performance targets. Examples include individual and group incentive plans, bonuses, spot awards, and profit-sharing plans.
3. Long-Term Incentives — variable pay awards tied to increases in shareholder value over periods greater than one year. Examples include various types of stock options and deferred cash plans
4. Benefits — mandatory and not mandatory benefit programs. Examples include health insurance, paid time off, and retirement programs.

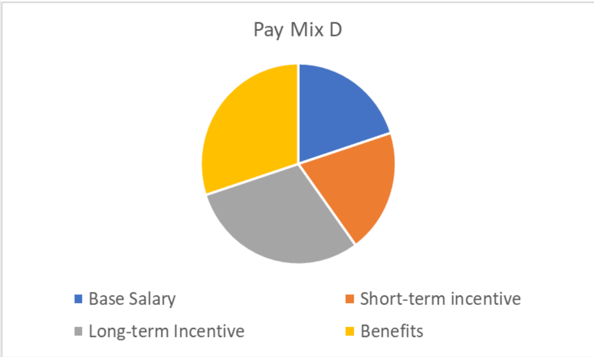
Instructions. Examine the four pay mixes below. Which pay mix would you expect to see for the listed positions? Why? Explain your answer by discussing how the various pay mixes attract, retain, and motivate the employee.

1. Unskilled, hourly worker
2. Marketing Representative
3. Operations Manager
4. CEO









Instructor's Notes

These are illustrative examples of possible pay mixes for different positions at a fictitious organization. However, these pay mixes reflect the pay practices at privately held companies in the U.S.

Position	Base Salary	Short-term incentive	Long-term Incentive	Benefits	Total Compensation
Marketing Rep (Pay Mix A)	35	30	5	30	100
Hourly worker (Pay Mix B)	65	5	0	30	100
Operation's Manager (Pay Mix C)	50	10	10	30	100
CEO (Pay Mix D)	20	20	30	30	100

While there are many options when it comes to setting a pay mix, every combination will have a different impact. Explanations for the various play mixes should include a discussion of the following factors:

Sorting effect. Different individuals will be attracted to different salary mixes. Base pay is used to attract and retain employees. Employee retention is most influenced by base pay and long-term incentives. Base pay offers income security. Incentive or variable pay represents a risk to the employee. Employees can only earn incentive pay if they achieve their performance goals. Individuals differ in terms of their risk tolerance and attraction toward variable pay. Employees need to stay with the organization and achieve long-term goals to earn valuable long-term incentives, such as deferred compensation and stock options. LTIs are effective retention tools organizations use to retain valuable talent in a competitive labor market.

Motivational effect. Short-term and long-term incentives have a motivation effect. Short-term incentives offer rewards to employees for achieving performance targets and are found at all levels in organizations. Sales-related positions often have short-term incentives because outcomes (sales) can be objectively measured, and there is a clear line of sight between performance and rewards. Long-term incentives are most often used for key management and executive positions. LTIs create a strong incentive for management members to achieve long-term financial performance targets and align management and shareholder interests.

Benefits beyond mandatory requirements such as workers' compensation, social security, and unemployment compensation are offered to attract and retain employees and maintain competitiveness (external equity) with other employers. According to the U.S. Bureau of Labor Statistics, in June of 2020, benefits costs averaged 29.8% of total compensation (https://www.bls.gov/news.release/pdf/ecec.pdf).