


Chapter 2

Designing a Compensation Strategy

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ABSTRACT

This chapter provides a comprehensive analysis of compensation design as a strategic lever for organizational success. It examines strategic compensation planning, highlighting the alignment of pay systems with business objectives to motivate desired behaviors, enhance productivity, and support long-term goals. Factors affecting employee compensation—including internal equity, external competitiveness, performance, skills, experience, and market benchmarks—are explored to inform effective pay decisions. The chapter distinguishes job evaluation from performance appraisal, emphasizing its role in establishing fair, transparent pay structures. Key features and methods of job evaluation—ranking, classification, point-factor, and factor comparison—are discussed, offering practical guidance for designing compensation systems that attract and retain talent, reinforce performance, and sustain competitive advantage in evolving business environments.

INTRODUCTION

Compensation is far more than the cost of doing business—it is a powerful lever for achieving organizational success when thoughtfully aligned with business goals (Armstrong & Taylor, 2020; Lawler, 2000). Strategic compensation planning ensures that pay structures not only reward individual and team performance but also drive broader objectives such as innovation, customer service excellence, and cost leadership (Gerhart & Fang, 2015). By linking reward systems directly to performance

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targets, organizations create a clear line of sight between employee contributions and strategic outcomes (Milkovich, Newman, & Gerhart, 2014).

A critical foundation of effective compensation design is job evaluation, the process of systematically determining the relative value of roles within the organization to establish internal equity (Dessler, 2017). Methods such as ranking, classification, point-factor, and factor comparison each offer distinct advantages and limitations, requiring careful selection to suit the organization's structure, culture, and strategic priorities (Dowling, Festing, & Engle, 2013).

Equally important is balancing internal fairness with external competitiveness. Internal equity ensures consistency and transparency in pay decisions, often achieved through well-defined pay structures and salary bands (Armstrong & Taylor, 2020). External equity, on the other hand, requires benchmarking against market rates to attract and retain top talent (Gerhart & Rynes, 2003). Organizations must navigate the delicate balance between these two dimensions while addressing challenges such as pay compression and wage gaps (WorldatWork, 2023). This chapter explores how compensation can be strategically aligned with organizational performance goals, presents practical insights into job evaluation methods, and examines approaches for achieving both internal and external equity in a competitive marketplace.

ALIGNING PAY WITH BUSINESS GOALS

In high-performing organizations, compensation is not simply an administrative function—it is a strategic tool for driving results (Gerhart & Fang, 2015). Aligning pay with business goals ensures that employee rewards directly reinforce the behaviors and outcomes the organization values most, whether that is fostering innovation, delivering exceptional customer service, or achieving cost leadership (Bloom & Milkovich, 1998). Strategic compensation planning creates a clear connection between performance expectations and rewards, motivating employees to contribute in ways that advance organizational priorities (Lawler, 2003). By integrating pay systems with strategic objectives, companies can strengthen engagement, improve retention, and sustain competitive advantage in a rapidly changing business environment (IBM, 2020).

Strategic Compensation Planning

Strategic compensation planning is the deliberate process of designing, implementing, and managing pay systems that are directly aligned with an organization's mission, vision, and long-term business objectives (Armstrong & Taylor, 2020). It goes beyond simply setting competitive salary levels by integrating compensation

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