The Role of Compensation Strategy in Achieving Firm Performance Outcomes: A Managerial Perspective

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Abstract

Linking compensation to firm's strategy is an important requirement for any compensation system. The underlying premise is that the higher the fit, organizations will be able to reach higher performance and competitiveness. This paper examined the level of compensation strategy and policy formalization in a post-transition European country and its role in driving firm competitiveness. Primary research was conducted among the population of Croatian companies that employ more than 100 employees. The research is based on the sample of managers from 61 company. Research results showed that slightly more than a half of companies have a formalized compensation strategy whose primary objective is to improve employee performance. There are differences in the level of management and expert engagement as well as in relative productivity compared to competitors depending upon the level of compensation strategy formalization. Still, only 36.1% of managers find that compensation strategy can have an impact on competitive advantage.

Keywords: compensation strategy, compensation policy, competitive advantage, firm performance

Introduction

Most companies nowadays understand that human resources (HR) are their most important asset. Employees with their skills and abilities can play the key role in reaching firms' performance objectives. Considering the fact that employees work for an employer in exchange for pay, firm's compensation plan has the most important role in attracting, motivating and retaining employees. The source of firm's competitive advantage, among others, can be people based (Barney, 1991), thus strategic management of compensation is becoming central to sustain firms' long-term competitive advantage (Gerhart & Rynes, 2003). The longer-term direction for compensation policies, practices and processes is expressed though compensation strategy. Compensation strategy should bring the organization to the achievement of organization's strategic objectives, established by organizational vision, mission and business strategy and it is in a way a declaration of intent which expresses what the organization wants to do in the longer term to develop and implement compensation policies, practices and processes that will support the achievement of its business goals (Armstrong & Stephens, 2005:25; Gerakos, Ittner & Moers, 2018).

Just as all organizations are different, compensation strategies also differ. The area of compensation system design offers a great plurality where managers and researchers need to discover organizational specifics and design contingent pay systems (Thorpe & Homan, 2000). Compensation strategy is a multilayered phenomenon: it provides a sense of purpose for pay policies and practices, but all with the aim of achieving higher, business goals. Similar aspects of compensation are found in compensation strategies of different organizations but they will be treated differently according to variations between organizations. Enhancing employee commitment and engagement is usually the final goal of any compensations system although the strategy to achieve it can differ greatly depending upon organizational characteristics (Milkovich & Newman, 2005). Several design issues need to be explored before adopting a certain compensation scheme. For example, a firm should consider among job or person-based pay, performance-based pay, market position, internal-external equity, centralized or decentralized compensation structure, degree of hierarchy, compensation mix, job security and the impact of seniority (Lawler, 2000). All these different features of the compensation system are included in the compensation strategy. As among business strategies, the most important feature of a compensation strategy is to explain the way how to get to a specific objective. Furthermore, without a compensation strategy it cannot be assured that employees will be compensated at fair rates of pay.

Up to the beginning of 1990s compensation systems in Eastern-European economies had limited possibilities to customize according to enterprise's objectives due to extensive rate of government control. An earlier qualitative research concluded that there is a lack of alignment between compensation strategy and business strategy in Croatian companies (Bakotić & Braje, 2017). Thus, it is interesting to examine how enterprises in an European post-transition economy adapted their compensation strategies to the market economy and increased competition for workforce. Additionally, most findings about compensation strategies and related outcomes are based on US companies, and do not take into account particularities of other countries (Tremblay & Chênevert, 2008). In this paper we examine compensation strategies of Croatian enterprises. The main research questions that will be explored in this paper are: (1) do Croatian companies use formal compensation strategies, (2) what is the relationship between compensation strategy and human resources/organizational performance outcomes and (3) what is the role of compensation strategy in achieving competitive advantage.

Compensation strategy and firm performance

Organizations use compensation as a tool to attract, retain and motivate employees and possibly to build competitive advantage that is difficult to imitate (Gerhart & Rynes 2003; Milkovich & Newman, 2005). As argued by Barney's (1991) resource-based view, only resources that are rare, valuable, imperfectly mobile, and inimitable through substitution can be the basis for the sustainable competitive advantage. In the attempts to use employee compensation as a source of sustained competitive advantage, organizations have been establishing compensation strategies and adapting their compensation systems accordingly. Based on Barney's work, Milkovich & Newman (2005) argue that three tests determine if pay strategy can act as a source of competitive advantage: (1) is it aligned (with business strategy, external factors and internally with other HR policies), (2) is it differentiated (from other companies and difficult to copy by other companies) and (3) does it add value (do organizations gain returns from this controllable expense).

Compensation strategies encompass numerous aspects that shape the overall compensation system. A firm's compensation strategy is therefore multidimensional and includes strategic compensation decisions such as intended pay mix (salary, benefits, incentives), market positioning and pay policies (Balkin & Gomez-Mejia, 1990); compensation time horizon (long term versus short term pay) (Yanadori & Marler, 2006). An organization's compensation strategy can be explicitly documented and revealed, for all to see and understand (Milkovich & Newman, 2005). In some cases companies do not state their compensation strategies, although it does not necessarily mean that they do not have compensation strategies; it just emerges from pay decisions they make.

In order for a clear strategic direction, compensation strategy should be congruent with corporate and business strategy (Balkin & Gomez-Mejia, 1990). In other words, corporate and business strategy will be one of the main factors that shape the overall compensation system (Balkin & Gomez-Mejia, 1990; Gomez-Mejia, 1992; Boyd & Salamin, 2001; Yanadori & Marler, 2006), but clearly not the only one. Compensation strategy will depend upon industry (Yanadori & Marler, 2006), technological intensity (Tremblay & Chênevert, 2008), ownership type (Werner, Tosi & Gomez-Mejia, 2005), national culture (Schuler & Rogovsky, 1998; Westerman et al., 2009) and globalization through transnational organizations (Phillips & Fox, 2003). Furthermore, compensation strategy can be tailored for different employee groups separately (Gomez_Mejia & Balkin, 1992; Yanadori & Marler, 2006; Yanadori & Kang 2011).

Pay policy choices include organization's administrative framework, criteria and procedural approaches used to remunerate its employees (Balkin & Gomez-Mejia, 1990). Just as compensation strategy, it is also multidimensional and includes dimensions such as individual performance policy, transparency of information, group performance policy, internal versus market equity policy and the level of decentralization of pay policies (Tremblay & Chênevert, 2008). It has been shown that the fit between business strategy and pay policy impacts firm performance and that pay policy must be tailored according to business strategy (Montemayor, 1996).

When properly designed, compensation system can be an important contributor to the accomplishment of the overall strategic objectives. Compensation can help to cascade business goals to employee level and helps to communicate company's priorities (Zingheim & Schuster, 2000). Some studies examined the combinations of business strategies and compensation systems that resulted with better performance (Rajagopalan, 1997) and emphasized the importance of such fit . The importance of compensation strategy to achieve firm performance has been proven by several authors (e.g. Gomez-Mejia, 1992; Janie Chang, Ou & Wu, 2004; Tremblay & Chênevert, 2008; Carey, 2008), although not all research results unanimously confirm this finding (e.g. see Tsai, Chou & Chen, 2008).

Methodology of Research

Sample and Data

This research is a part of a larger project aimed at exploring compensation practices is Croatia. The population for the primary research included medium and large-sized Croatian companies since those are expected to have developed formalized HRM practices, amongst others the compensation strategy. The population of Croatian companies that employ more than 100 employees is approximately 1700 companies (excluding banking and finance sector), out of which 386 companies employ more than 250 people (labelled as "large companies"). A questionnaire containing 46 questions was designed by authors for the purpose of primary data collection. Respondents to the survey were human resources managers or human resources experts.

The independent characteristics of the companies in the sample are given in a summary table below (Table 1). The statistical analysis of the primary data was conducted by using IBM SPSS 21 software.

Table 1: Data Distribution by Sample Characteristics

Company characteristic	**Total sample (n=61)**
Industry	Manufacturing – 57.40%, Services – 42.60%
Year of establishment	Before 1990 – 45.90%, After 1990 – 54.10%
Number of employees	Less than 250 – 50.80%, More than 250 – 49.20%
Legal form	Joint stock company – 32.80%, Limited liability company – 67.20%
Profitability in the last 5 years	Cannot assess – 1.60%, Unprofitable – 4.90%, Around or below average – 23.00%, Profitable – 70.50%
Productivity compared to competitors	Significantly below average – 1.7%, Slightly below average -1.7%, Around average – 41.4%, Above average - 43.1%, Significantly above average – 12.1%

Source: Author's work

As shown in Table 1, research sample included companies with long tradition established before 1990 (45.9%) and those established during or after the transition period that started in 1990 (54.1%). The sample had similar proportion of companies with less than 250 employees – medium companies (50.8%) and more than 250 employees (large companies; 49.2%). This research covered both joint stock companies (32.8%) and limited liability companies (67.2%). According to the companies' self-reported profitability in the last 5 years, 70.5% of companies were profitable, 23% were of average or below average profitability and 4.9% were unprofitable. Similarly, when productivity compared with competitors is taken into consideration, 3.4% of companies were below average, 41.4% around average and 55.2% above average. With respect to ownership structure, the sample consisted of 57.4% of companies with majority private domestic ownership (n=35), 32.8% of companies with majority private foreign ownership (n=20) and 9.8% of companies with either state (public) ownership or mixed ownership.

Research Instrument

A questionnaire for the primary data collection was designed by authors and included 46 questions that aimed at exploring different aspects of reward practices. Majority of key questions about reward management strategies were found or adapted in different journal articles as well as *Chartered Institute for Personnel Development* internal materials. Respondents to the survey were HR managers or specialists. Researched variables were of nominal or ordinal character and control variables were designed almost exclusively as closed-ended questions, such as ownership type, profitability in the last five years and legal form of the company. Several open-ended questions were present as well (e.g. year of establishment, industry, number of employees). Some variables of interest were assessed on a Likert type scale, e.g. profitability compared to competitors).

Statistical Analysis

Frequencies were used to describe the occurrence of compensation strategy and policy, as well as its objectives. The non-parametric Kruskal Wallis test was used to test for statistically significant differences in the (1) human resource and (2) organizational performance indicators among groups of companies with different levels of compensation strategy and policy formalization. Dunn's post hoc test was used to test for differences between groups.

Results

Table 2: Level of compensation strategy formalization

	Frequency	Percent
Developed, represents the core element of general HRM strategy and general strategic plans	32	52.5
Partially included in HRM strategy, but not fully developed	17	27.9
Not developed	12	19.7
Total	61	100.0

Formalized compensation strategy should enable compensation system to act as one of the drivers of firm's competitiveness. Research results indicate that among medium and large sized companies, approximately one half have fully developed and formalized compensation strategy (Table 2). The rest of companies have either compensation strategy included within the HRM strategy (27.9%), or have not developed compensation strategy at all (19.7%). An integral part of compensation strategy are compensation policies that should be also formalized. Among the researched sample, as showed in Figure 1, 51% of examined companies have formalized compensation policies which corresponds to the percentage of companies with formalized compensation strategy. Additional 41% of companies have partially developed compensation policies, with a relatively low percentage (8%) of companies that have not formally developed their compensation policies.

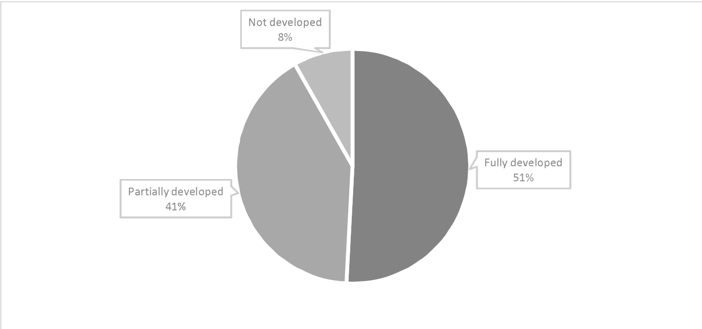

Figure 1: Level of development of compensation policies

The purpose of establishing reward strategy and policies is to achieve some predetermined objective. In the case of examined companies, for most companies this is improving individual performance (96.7% of companies). Beside improving individual performance, these objectives include improvement in product or service quality (65.6% of companies), increasing employee responsibility (57.4%) or retaining employees (36.1%).

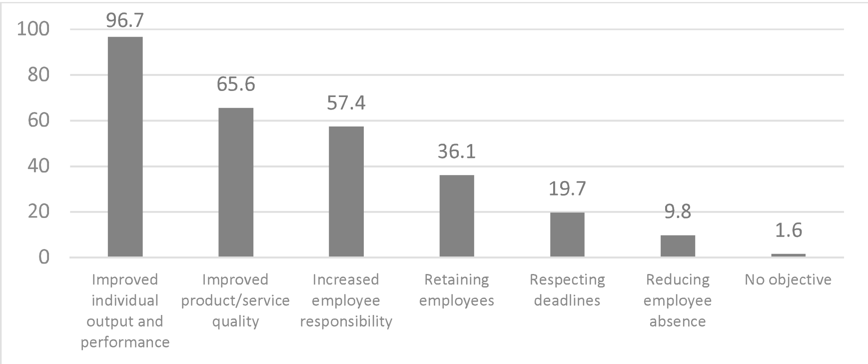

Figure 2: The objective of compensation policies

In order to test for the impact of compensation strategy on performance, human resource performance was operationalized through three measures – the problems associated with (1) attracting, (2) retaining and (3) engaging three categories of employees (managers, experts and other lower level employees). It was evaluated on a three-point scale: none, some and great problems with attracting/retaining/engaging employees. In order to determine if the level of compensation strategy formalization is related to human resource performance, Kruskal Wallis test was conducted. Results shown in Table 3 indicate that a statistically significant difference is found only for the indicator “problems with engaging managers” ($\chi2=7.2$, $p<0.05$). Dunn’s pairwise post-hoc test showed a statistically significant difference between companies with formalized compensation strategy and those without any compensation strategy (p=0.022), with rank scores indicating that companies without compensation strategy had more problems with engaging managers.

Table 3: Existence of compensation strategy and human resources performance

	Attracting			Retaining			Engagement		
	Managers	Experts	Other employees	Managers	Experts	Other employees	Managers	Experts	Other employees
Chi-Square	,120	,331	1,545	1,530	2,111	,161	7,197	5,618	1,680

df	2	2	2	2	2	2	2	2	2
Asymp. Sig.	,942	,848	,462	,465	,348	,923	**,027**	,060	,432

As a part of the research, it was analyzed to what extent can the existence of reward policy be related with human resources performance. Results shown in Table 4 indicate that some statistically significant differences were found with experts' ($\chi2 = 7.8$, $p<0.05$) and management ($\chi2=8.5$, $p<0.05$) level of engagement when taking into consideration the development of reward policy. Dunn's post hoc test showed that in both cases statistically significant differences exist between companies with partially developed compensation policy and those with a developed compensation policy. Descriptive analysis indicates that companies with fully developed reward policy had lower problems with engaging managers and experts than other companies.

Table 4: Existence of compensation policies and human resources performance

	Attracting			Retaining			Engagement		
	Managers	Experts	Other employees	Managers	Experts	Other employees	Managers	Experts	Other employees
Chi-Square	,913	1,663	1,854	,872	2,069	2,373	7,760	8,535	4,866
df	2	2	2	2	2	2	2	2	2
Asymp. Sig.	,634	,435	,396	,647	,355	,305	**,021**	**,014**	,088

Organizational performance was self-reported as respondents were invited to rate (1) profitability in the past five years and (2) relative performance when compared to their competitors. No statistically significant differences have been found when exploring presence of compensation strategy or policy and companies' 5-year profitability. Table 5 indicates that there is a statistically significant difference in the productivity compared to competitors when companies are grouped according to (1) the formalization of compensation strategy ($\chi2 = 7.3$, $p<0.05$) and (2) the existence of compensation policy ($\chi2 =11.6$, $p<0.05$). With respect to compensation strategy, post-hoc test showed statistically significant difference between companies that have developed compensation strategy and those companies that do not have compensation strategy ($p=0.069$). Mean rank indicated lower productivity among companies that do not have developed compensation strategy. Additionally, Dunn's post hoc test showed that with compensation policy statistically significant differences exist with productivity compared to competitors between companies with partially and fully developed compensation policy, with mean rank indicating lower productivity among companies with partially developed compensation policy (when compared to companies with developed compensation policy).

Table 5: Existence of compensation strategy and policies and organizational performance

	Productivity compared to competitors	**Productivity compared to competitors**
Chi-Square	7.366	11.612
df	2	2
Asymp. Sig.	.025	.003
	Grouping Variable: formalization of compensation strategy	Grouping Variable: existence of compensation policy

The last set of analyses was designed to answer the third research question: what is the role of compensation system in improving firm's competitiveness. Table 6 indicates that among examined companies, 36.1% of managers consider that the reward system in their companies strongly impacts competitive advantage. Additional 39.3% of managers find that reward system has a moderate impact on competitive advantage which makes ¾ of examined managers that find compensation system as an important source of competitiveness. Table 6 also shows that managers in companies with a formal compensation strategy in higher percentages recognize the importance of compensation in improving firm's competitiveness.

Table 6: The role of compensation system in improving firm competitiveness

	The impact of reward system on competitive advantage				Total
	No impact	Minor impact	Moderate impact	Strong impact	
Developed, represents the core element of general HRM strategy and general strategic plans	0%	15.6%	34.4%	50.0%	100.0%
Partially included in HRM strategy, but not fully developed	0%	35.3%	35.3%	29.4%	100.0%
Not developed	16.7%	16.7%	58.3%	8.3%	100.0%
Total	3.3%	21.3%	39.3%	36.1%	100.0%

As a part of the research, managers were asked to report their opinion on the two criteria Milkovich and Newman (2005) used to rate the impact of compensation strategy to the creation of competitive advantage. Results indicate that 31.1% of examined managers reported that the compensation system is difficult to imitate, which indicates that in the remaining 68.9% of companies' compensation system can be easily copied by their competitors. However, 88.5% of examined managers reported that the compensation system brings to the creation of new value. Still, just creation of competitive advantage is not enough to use compensation system as a source of competitive advantage. Only 29.5% of managers reported that their compensation system is both difficult to imitate and adds new value and therefore fulfills the requirements to be considered a source of competitive advantage.

Discussion and Conclusion

In attempts to use compensation system as a tool to increase company's competitiveness, companies should establish formalized compensation strategy and policy that would serve as a guideline for the overall compensation system. Formalized compensation strategy is mostly a standard document for companies operating in developed countries, but in the examined post-transition country it is formally established as a separate document by 52.5 % of examined companies. Still, 19.7% of all examined companies did not establish compensation strategy. Compensation is usually the highest operating cost for any company, so it would be very beneficial for companies to have a formalized compensation strategy because in this way they could assure additional control over this extensive cost, as well as use this cost to achieve company's objectives. In the times when companies are constantly competing for top talent employees, a clearly defined compensation strategy could act as an additional incentive to attract new employees to the company, as it would provide them with clear information what to expect from the employment within such company (in terms of compensation).

The compensation strategy is translated into practice through compensation policies. Compensation policies define different mechanisms that will be used to support the fulfillment of compensation strategy and overall firm objectives. Just as with compensation strategy, it can also be clearly defined, stated or unstated. Research results indicate that 51% of managers reported that their companies have a clearly developed compensation policy. When research results on the presence of compensation strategy and policy are combined together, it can be concluded that approximately a half of examined companies in Croatia have reached the level of "best practice" prescribed by the practitioners and academics from the developed countries. Such research result is promising, since it must be emphasized that in the 1990s all companies started with a centrally planned compensation with very limited possibilities to customize their compensation strategies according to company's contingencies. In many cases the leaders of changes in the overall compensation systems were foreign owned companies that transferred their parent-company practices to subsidiaries operating in Croatia. The sample consisted of 32.8% of companies with majority foreign ownership which indicates that domestically owned companies have been also following good practices in the development of compensation systems. In most cases, the objective of implementing compensation strategy is to improve employee performance; taken that employees have been a recognized source of competitiveness (Barney,1991) changing employee attitudes and behaviors in the right direction can lead to competitive advantage in the long run.

The second research question of this paper was to explore the relationship between compensation strategy and several performance outcomes. Statistical tests revealed a small number of statistically significant differences in performance levels depending upon the level of compensation strategy and policy formalization. Results indicate that companies which did not develop compensation strategy might have greater problems with engaging managers than companies with developed compensation strategy. With respect to compensation policy, research results indicate that companies with partially developed compensation policy have greater problems with engaging experts and managers than companies with fully developed compensation strategy. Other researched human resources performance indicators did not show a statistically significant differences depending upon the level of development of compensation strategy/policy. Therefore, it can be concluded that companies use some other tools to attract, retain and engage their workforce, and that the compensation system is not the only tool to improve human resources performance. Still, compensation strategy and policy can act as a mechanism that improves relative productivity compared to competitors. Statistically significant differences found indicate that companies with developed strategy have relative performance different that companies that did not develop compensation strategy. The same result was found among companies with fully and partially developed compensation policy. Relative performance was higher among companies with more developed compensation strategy/policy.

The third research question focused on the role of compensation strategy in reaching competitive advantage. Managers' views on the importance of compensation system in reaching competitive advantage indicate that approximately 75% of examined managers find compensation as an important source of competitiveness. Considering the fact that respondents to the survey were human resource managers/experts whose objectives are to have a stable and engaged workforce, it was expected that an even higher percentage of managers would emphasize the importance of compensation strategy as a tool to increase firms' competitive advantage. Possible reasons for such finding can be that Croatian companies try to build competitiveness on more traditional sources, or just because they are less competitive compared to companies in developed countries so, as a consequence, do not have the possibility to develop their compensation system in a manner to bring to more value, as Milkovich & Newman (2005) proposed.

When all research results are taken together, it can be concluded that companies from post-transition economies follow compensation practices established by companies in developed countries. Most companies have already established compensation strategy and policy in some formal manner, with the final objective to improve employee performance and thus reach overall firm performance standards. When it comes to manager's views on the role of compensation strategy in achieving firm performance outcomes, it must be emphasized that not all managers believe that compensation can really act as a source of competitiveness. Almost 85% of managers from companies with developed compensation strategy find that it is an important source of competitive advantage, compared to 64.7% of managers in companies with partially developed compensation strategy.

This research has several limitations: a relatively small sample size and self-reported data on performance limit the overall value of the research. The questionnaire was filled out by one person only, HR manager, which implies the response bias although the expertise of our respondents could be deemed unquestionable, as they were members of the corporate HR team. In the future, the questionnaire could be distributed personally and be followed by an interview. Performance indicators could be collected from objective sources. Additional independent data could be impaired with data gathered by cross-sectional research, i.e. financial indicators from public reports which would add more strength to findings and avoid response bias in questions that referred to financial and organizational performance of companies in the sample.

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