IVEY BUSINESS JOURNAL
IMPROVING THE PRACTICE OF MANAGEMENT

Redefining total compensation to include the value of job security

By Patrice Gélinas

November/December 2005
Reprint # 9B05TF12

Ivey Business Journal Online is published by Ivey Management Services a division of the Richard Ivey School of Business.
For subscription information,please contact: ibjonline@ivey.uwo.ca
www.iveybusinessjournal.com

To order copies or request permission to reproduce materials, please contact: Ivey Publishing, Ivey Management Services
c/o Richard Ivey School of Business, The University of Western Ontario, London, Ontario N6A 3K7
Tel: (519)661-3208, Fax: (519)661-3882, Email: cases@ivey.uwo.ca

Redefining total compensation to include the value of job security

Job security, once the most treasured and tangible benefits of the smokestack era, is vanishing. It isn't just the disappearance of smokestack industries, but outsourcing and the globalization of markets have caused huge job losses. Job security may not be right for every industry, but as this author argues, where it is right and where it is valued, the promise of job security can and should be incorporated into an employee's total compensation package.

By Patrice Gélinas

Patrice Gélinas is an assistant professor at the School of Administrative Studies, York University. He is also an actuary and a compensation consultant.

Benchmarking pay competitiveness is a periodic routine that has never been more critical. Rapid technological developments, skilled employee shortages, increased workforce mobility, and global competition are transforming pay expectations and forcing managers to consider each compensation dollar they spend thoroughly. The coinciding entry of the head-hunted "Generation Y" into the workforce, with its distinctive goals, values, and work-life balance aspirations, challenges employers further. The Y workers grew up with their - usually divorced - boomer parents and saw them dedicate their life to their careers, only to share the pain of massive lay-offs. More than ever, the workforce is aware that nothing lasts forever.

In this context, it is important to ask what can employers offer that is valuable enough to increase their odds of attracting and retaining the best and brightest. The answer: an option. Not one more stock option, but the option to remain employed with the company in the future, better known as job security. The traditional definition of total compensation includes salary, annual bonus, long-term incentives, pension and other benefits, and perquisites. It is less and less adapted to reality as it no longer allows for adequate comparisons between different pay opportunities. This is mainly because the definition of traditional compensation does not capture the fact that many sectors of the employment market have become frighteningly precarious. Nowadays, many workers do, or would, accept a salary cut in return for assurance of employment. Employers need to recognize and integrate the value of job security as a component of total compensation when they benchmark the competitiveness of what they offer. Two equivalent corporate jobs with similar salaries, incentives, and benefits are simply not equally attractive for an employee if their underlying risk of involuntary termination differs. On the other hand, the offer of job security would make one of the jobs more attractive.

Attention to job security is important because insecurity is associated with several factors that compromise performance, including an intention to quit, reduced commitment, and reduced job satisfaction (S. Ashford et al., "Content, Causes, and Consequences of Job Insecurity: A Theory-Based Measure and Substantive Test", *Academy of Management Journal*, 1989, Vol. 32, No. 4, pp. 803-829). Job insecurity can also reduce organizational performance because of its detrimental effect on employees' health: reduced psychological well-being, psychosomatic complaints and physical strains (H. De Witte, "Job insecurity and Psychological Well-being: Review of the Literature and Exploration of

Some Unresolved Issues", *European Journal of Work and Organizational Psychology*, 1999, Vol. 8 (2), pp. 155-177).

In this article, I present and discuss the building blocks of a "new" total compensation strategy that incorporates job security:

- Several types of job security that an employer can consider offering to attract and retain talent;
- Challenges associated with the approximation of the dollar value of job security;
- An illustrative example of a valuation for the purpose of a total compensation analysis; and
- What we know about which employers are more likely to obtain a net benefit out of providing job security.

I conclude by presenting the reasons why the value of job security will represent an increasing proportion of the total compensation package in the future.

Job security's many faces

Job security is not a concept that is universally and clearly understood. The academic, labor relations, legislative, and journalistic literatures use a variety of notions which are, most of the time, implicit or barely defined. Following a thorough review, the Institut de recherche et d'information sur la rémunération (IRIR, "*La sécurité d'emploi: mythes et réalités - Job Security: Myths and Reality*", June 1994) proposed an interesting starting point to define job security:

> *"Job security is the relative assurance, owned by an employee, that he/she is shielded against damages that would result from the loss of his/her job."* (Translation by author)

This definition encompasses a spectrum of job security arrangements. For most managers and workers, job security rhymes with a government job because the public sector provides *absolute* job security, where the chances of being involuntarily terminated without cause are virtually nil. Private sector employers reduce the prospect of job insecurity differently, sometimes without a formal contractual agreement. For example, Warren Buffett promises his NICO workforce that "no one will be fired because of declining volume, however severe the contraction" (2004 letter to shareholders of Berkshire Hathaway, page 8). Job insecurity can also be reduced by the mere fact that an employer is in a favorable competitive position. *Contextual* job security accordingly arises out of a combination of the employer's economic health and staffing policies. Job security can also be *temporary*, because of fixed-term guaranteed employment contracts or rolling fixed-term contracts. The latter provide continuous employment until the end of a predetermined period that only starts upon an employer's formal notice of non-renewal. The job security that workers acquire by themselves with the accumulation of sought-after skills, of personal relationships, or of client networks, is beyond the scope of this text.

Job security is valued unequally by employees

Assessing the compensation dollar value that employer-provided job security represents is challenging because the value varies according to market-wide conditions as well as individual employee characteristics. Examples are presented in Table 1, which suggests that job security will be most valuable for newly-hired individual "A" who is: young, unskilled, financially committed, and attached to his/her economically-challenged region of residence where the cost of living is modest. By contrast, job security offers would be least likely to be helpful when trying to *recruit* individual "B" who is: highly-skilled, close to retirement, financially secure, and mobile. Psychology studies also reveal that an individual's attitude towards the risk of employment loss determines the perceived value of job security.

TABLE 1 – Some determinants of the value of job security for an employee*		
	Determinants	*Impact on value*
Market-wide conditions	Economic conditions:	
	Higher unemployment rate	+
	Higher compensation loss associated with job loss	+
	Lower cost of living in existing area of residence	+
	Faster pace of technological changes that can make existing skills obsolete	+
Individual circumstances	More years to retirement	+
	Higher demand for skills	-
	Higher financial commitments	+
	Relocation challenges:	
	Greater attachment to the area of residence	+
	Higher perceived importance of the existing social network	+
	Higher spouse's ability to find another occupation	-
	Higher cost of acquiring new skills following termination	+
	Higher anxiety towards uncertainty	+
	Longer life expectancy	+

* See the previously-cited IRIR document for detailed references.

Whereas the value of job security is near zero for individual "B", the following example illustrates how valuable it can be for individuals sharing traits with profile "A". Assume that one of these individuals is 30 years old and has a job that pays $50,000 annually, including salary, incentives, the approximate annualized value of pension and other benefits and perquisites. The value of compensation is anticipated to grow at a rate of 3% annually, which includes both merit and cost-of-living increases, until retirement at 65. For simplicity, let's assume that this worker could, at any time, find another job that pays 80% of what he/she earns at that point. Social-support nets therefore would never be used.

For comparative purposes, Table 2 provides values of job security, as a percentage of compensation, assuming that similar positions are found at each of the following employers:

- A governmental organization offering absolute job security;
- A large, healthy corporation whose financial strength is reflected in a very high rating from debt rating agencies; and
- A large, unstable corporation whose debt is on the verge of junk status.

In Scenario 1 of Table 2, we are being extremely conservative and assume that the only possible reason for involuntary termination is the employer's imminent bankruptcy (which is obviously impossible for the governmental organization). In scenario 2, we still include the risk of bankruptcy as a cause for termination and add an annual involuntary turnover probability of 1%. In Scenario 3, the involuntary turnover probability is 5%.

In our example, the net advantage of benefiting from absolute security can be as high as 14.4% (i.e., 20.0% - 7.6%) of traditional compensation when a government employee is compared with an unstable corporation employee whose risk of involuntary turnover is 5% annually. When the latter is compared to an employee in a healthy corporation where the annual involuntary turnover is 1%, the job security value gap is 6.8% (14.4% - 7.6%) of traditional compensation.

Note that, like in many prior studies, the results presented in Table 2 only reflect the risk-adjusted present value of the financial loss (i.e., annual compensation reduction) associated with an involuntary job termination. A more through analysis should quantify other benefits of job security, such as financial and psychological well-being.

A "new" total compensation

As mentioned before, total compensation analyses that employers use to benchmark the competitiveness of their pay packages typically define total compensation as the sum of salary, annual bonuses, long-term incentives, retirement and other benefits and perquisites. This approach can be valid in three instances:

1. Jobs under review are clustered within a narrow set of employers that all provide similar job security (e.g., a comparison of the pay of social workers, most of which are employed by governments, across several provinces).
2. Job security is explicitly included as an employment condition in the description of the benchmark job. That is, jobs without comparable job security would be rejected by compensation professionals conducting the benchmark study because they represent an imperfect match.
3. Job security is highly likely to have a near-zero value for the jobs studied (e.g., an executive specialized in corporate turnarounds or start-ups).

In most total compensation reviews, however, the value of job security is relevant. Chart 1 compares the results of total compensation analyses under each of our scenarios. When job security is ignored as a component of total compensation, governmental and corporate employers appear to pay competitively (i.e., $50,000). However, when our estimate for the value of job security is added to the total compensation equation, the analysis reveals that the governmental pay package stands above that provided by corporate employers. As expected, involuntary employee turnover also decreases the compensation value of job security.

Total compensation adjustments

Should an organization whose "new" total compensation stands below that of its peer group catch up by increasing cash compensation or benefits, or by improving the job security it offers? For example, instead of providing significant salary increases, should the organization agree to limit or reduce outsourcing?

Scientific research results are mixed on employers' return on investments in job security. Some organizations obtain net gains from reducing their human resource allocation flexibility in return for a more stable, motivated and productive workforce. In contrast, some organizations do suffer from the stereotyped employee who (mis)uses job security as an opportunity to reduce daily work efforts (refer to P. H. Loseby, *Employment Security: Balancing Human & Economic Considerations*, Quorum Books, Greenwood Publishing Group, Inc., 1992).

Job security should therefore be managed, like every other compensation component, within a strategic staffing framework that espouses the organizational culture. If business volume is stable enough to provide job security at a reasonable cost, and if employees value job security highly, then increasing total compensation by improving job security guarantees can be the most suitable way to increase total compensation. Otherwise, it is probably safer to provide compensation increases by changing compensation components that adapt to a variable business volume or that are more likely to attract, retain, and motivate the workforce.

The years ahead

Looking ahead, the growing globalization of markets will increase the value of job security to make it one of the most important components of total compensation. There are two main reasons for this. First, many organizations face increasingly tough competition, which increases job insecurity. Tangible signs of this shift are already apparent. For example, the recently (2005) ratified agreement between the Canadian Auto Workers and Ford Motor Co. of Canada has been described by CAW President Buzz Hargrove as a "modest agreement, but a good agreement in tough times." Ford's 12,000 Canadian employees obtained their smallest salary increases since 1985. Ford's eroding market share and the ensuing shift in the union's attitude to protect existing jobs illustrate clearly how the value of job security is increasingly crucial in the total compensation equation. This is especially true these days, when Ford's similarly-challenged competitor, General Motors, announced cuts of 3,900 jobs in Ontario and 30,000 jobs worldwide.

The second reason why the value of job security will increase is that outsourcing opportunities are on the rise, especially to low-labor-cost countries. For example, India now welcomes outsourcing mandates in the area of IT, data entry, programming, business process, back-office operations, infrastructure, communications, networking, media, entertainment, operations, relationships management, medical transcription, and on-site assistance (www.outsource2india.com). The trend towards outsourcing more and more business functions, especially to foreign providers, creates uncertainty concerning future demand for skill sets that local individuals have developed. The value that individuals will attach to their own peace of mind concerning future employment will therefore increase as international outsourcing continues to develop. I

Table 2 and Chart 1 are on the following pages

TABLE 2 –Value of job security (as a percentage of salary, incentives, pension and other benefits and perquisites) if the job found following involuntary termination only pays 80% of the secured job[1]

		Termination Risks Assumptions		
		Imminent bankruptcy is the only possible cause for termination	Imminent bankruptcy + 1% annual involuntary turnover	Imminent bankruptcy + 5% annual involuntary turnover
Employer	Public sector*	20.0%	20.0%	20.0%
	Healthy corporation	16.3%	14.4%	9.1%
	Uncertain corporation	12.7%	11.3%	7.6%
Benchmark	Terminated Employee	0.0%	0.0%	0.0%

* Termination risks do not apply.

[1] Results are for illustrative purposes only and are obtained based on a human capital valuation model. The model calculates the probability-adjusted present value of at-risk pay. Many valuation hypotheses are omitted in the text and each of them is debatable. I believe that my valuation assumptions are consistent with current market conditions. Please do not hesitate to contact the author for further information.

Chart 1 – Total compensation comparisons including the estimated dollar value of job security