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The Transition from a Seniority-Based Pay System to an Annual Salary System in Korean Enterprises

By

Hee-Tak Ahn

Abstract

Recently, there has been an increase in the number of companies which are trying to introduce the annual salary system in Korean enterprises. In order to cope with new business environment, the enterprises are trying to adopt new wage systems through a shift from wages based on length of service to those based on capability and performance. Although companies adopting the annual salary system are not so many, the number is expected to rise.

However, the practice of harmonizing seniority-based pay with the annual salary system will prevail. The annual salary system of Korean companies is not being implemented by taking performance as the main criterion, but rather by adding such new factors as capability and performance to the current wage system. It may take a long time for the annual salary system to take root in Korean enterprises where the corporate culture of seniority prevails.

Key Words

seniority-based pay, wage differentials, annual salary, merit ratings, stabilization of wages, performance, job-based pay, salary inversion, personnel management, length of service and age, capability-based pay, basic pay

Introduction

There are considerable differences among the wage systems of different countries according to pay structures or forms. European or American companies have generally adopted a job-based pay system under which wages are determined according to the relative value or difficulty of the job, whereas their Korean and Japanese counterparts have tended to implement seniority-based pay systems which emphasize seniority elements such as length of service and age.

However, pay systems in Korean enterprises have recently undergone great changes following the adoption of the capability-based pay or annual salary system. The annual salary system can be defined as a pay system which places emphasis on performance by determining the next year's wage through an evaluation of a worker's performance and contribution during the current year, while excluding the element of seniority.

This change in the Korean pay system has been accelerated by the recent rapid

alterations in the environment of business management. These changes include internationalization, globalization, changes in industrial structure, the raising of both wages and the academic level of the workers, changes in the attitudes of workers, and diversification of forms of employment. As reconsideration of personnel and wage policies based on seniority has become inevitable in order to strengthen international competitiveness, Korean companies have started to consider adopting the annual salary system for white-collar workers and professional staff. The annual salary system means that the salary is determined on a yearly basis in due consideration of the employee's performance and capability.

From this point of view, this paper will discuss the characteristics and limitations of annual salary systems in Korea by examining the elements of seniority in Korean pay systems, the background of the introduction of the annual salary system, the current status of its adoption, and its actual implementation in individual enterprises.

The Seniority-Based Pay System in Korean Companies

The pay systems of Korean companies can be characterized as being based mainly on seniority. In the seniority-based pay system, the wage is raised or determined according to a worker's age or length of service.¹

It is necessary to examine two aspects of Korea's pay systems to confirm that they are based on seniority. One aspect is the curve of wage increases and the other is the criteria used for wage determination.

Seniority-Based Pay in Terms of the Wage Increase Curve

In the first place, the relationship between wage and seniority elements may be analyzed on the basis of statistical data to confirm whether these elements have a practical influence. According to the transition of wage differentials for each age group shown in a survey on wages and hours of work made by the Ministry of Labour [MOL], wage differentials by age in 1980 showed that wages for workers aged 55 to 59 stood at 282.3 when those for workers aged 20 to 24 were set at 100, which means the former is almost three times more than the latter. The same age group recorded 2.4 times more wages (237.1) in 1986. Wage differentials among workers of different ages tend to decrease every year, whereas the tendency that wages increase markedly as workers get older remains the same (MOL, 1980-86). This can be attributed to the close relationship between age and wages.

Wage differentials by length of service are also very significant. In 1986, wages of workers with three to four years of service were 131.1, those of workers with five to nine years of service were 180.1, and those who had served more than 10 years stood at 263.4. This compared to 100 for workers with less than one year of service. Wage differentials by length of service have tended to decrease every year. In 1994, however, there was no essential difference because of the high rate of wage increase brought about by length of service.

The relationship between length of service and wages becomes more evident in the

¹Refer to the following books for the background to the establishment of the seniority-based pay system in Korean companies. Jung-Dae Kang. *Modern Wage Management*, pp. 159-161, Pakyoung Press, 1992. Kyu-Chang Lee. *Measures for the Improvement of Wage Structures*, pp. 84-85. Korean Chamber of Commerce and Industry, 1986.

case of company K. The wages of university-graduate workers with five, 10, 15, and 20 years of service were 137.4, 205.3, 239.8 and 278.4 compared to those for workers with one year of service, which were set at 100. The same tendency can be found in workers who graduated from high schools. These facts lead to the conclusion that the wage systems of Korean companies are based on seniority, and the relationship between age or length of service and wages is very strong in this system.²

Seniority-Based Pay in Terms of Criteria for Wage Determination

This chapter will examine seniority-based pay systems on the basis of the criteria for wage determination prevalent in Korean companies. Various data on the types of Korean pay systems show that comprehensive wages or seniority-based pay has been adopted by the majority of companies.

According to a survey made in 1990 by Choon-Sik Ahn and Hee-Tak Ahn, the task-based pay, the personal traits-based pay and the complex pay were respectively 19.8 percent, 25.6 percent, and 54.6 percent for white-collar workers (Ahn and Ahn, 1991, p. 67). If it is taken into consideration that many elements of seniority are included in the complex pay, the personal traits-based pay system may be viewed as

Table 1. Patterns of Pay Systems in Korean Companies

(Unit: Percent)

Occupat'n	Industry	Task-based pay		Pay-based on personal traits	Complex pay		
		Job-based pay	Pay-based on job & capability		Complex pay	Pay-based on seniority & job	Pay-based on seniority & capability
White-collar workers	Light industry	6.8	4.5	27.3	26.4	25.0	—
	Heavy industry	8.7	11.6	27.5	29.0	18.8	4.3
	Other manufacturing inds	20.0	8.6	28.6	25.7	5.7	11.4
	Finance & insurance	4.0	4.0	28.0	36.0	20.0	8.0
	Other industries	22.2	3.7	18.5	31.5	18.5	5.6
	Total (100.0)	12.8	7.0	25.6	31.3	18.0	5.3
		19.8			54.6		
Blue-collar workers	Light industry	7.7	10.3	33.3	28.2	10.3	10.3
	Heavy industry	9.4	10.9	25.0	21.9	17.2	15.6
	Other manufacturing inds	17.1	8.6	22.9	25.7	11.4	14.3
	Other industries	23.8	4.8	19.0	38.1	9.5	4.8
	Total (100.0)	12.6	9.4	25.8	26.4	13.2	12.6
		22.0			52.2		

Source: Choon-Sik Ahn and Hee-Tak Ahn, 1991.

²The relationship between age and wage is greater than that between length of service and wage. Refer to Korea Personnel Management Society (1982).

being the dominant type. The same applies to blue-collar workers.

The element of seniority also has great influence in the determination of wage increases. A survey made by Choon-Sik Ahn and Hee-Tak Ahn (Ahn and Ahn, 1991) showed that the most influential element for wage increase decisions was length of service, followed by individual capability (26.6%) and performance (19.6%) (Ahn, 1992, p. 68). Length of service was the most influential element in every kind of industry except for clerical workers within the heavy industry sector.

Even in the case of individual companies, we can rarely find wage increases for individual workers being awarded according to the results of merit ratings, apart from regular wage increases given through collective wage negotiations. The results of merit rating have not been reflected in the wage determination. Most companies confer regular wage increases on all their employees simply according to years of service.³ The heavy weight given to years of service in raising wages can be attributed to the fact that the Korean wage system is grounded on seniority-based pay.

Considering all these facts, the pay system of Korean companies may be characterized as being based typically on the criterion of seniority. The element of seniority is strongly reflected in the system in terms of wage curves and the criteria for wage decisions.

Background to the Introduction of the Annual Salary System and the Current Status of its Adoption

Background to the Introduction of the Annual Salary System

Recently, there has been an increase in the number of companies which are trying to introduce the annual salary system for managerial staff. This tendency may be attributed mainly to the various problems of the seniority-based pay system.

Basic pay, the main component of the pay structure of Korean companies, follows the typical pattern of the seniority-based pay system (refer to Ahn, 1992; Ahn, 1994b; Chung, 1992; Kim, 1993). Accordingly, when a worker enters the company, his pay is determined by his academic level. After joining the company, his age or years of service is considered as the main term of reference in the determination of his pay. Thereafter, his pay is augmented in proportion to the increase of his age or years of service. Therefore, a worker's capability, performance, and contribution are not taken into account in the determination of pay, and wages are awarded at predefined rates. Not only basic pay but also bonuses are given to workers on a uniform and fixed rate, regardless of individual performance. Merit ratings in Korean companies are exclusively used as a standard for promotion, and not as criteria for increases in wages or bonuses (Ahn, 1994a, pp. 55-56).

The wage systems of Korean companies, therefore, may be described as being intended for stabilizing the workers' livelihoods rather than for improving productivity or as motivational tools. One of the main reasons for this phenomenon is the Declaration of Democracy made in 1987. After that declaration, trade union activities became much more lively and the organisation rates of unions increased, which augmented

³More than 80% of Korean companies have adopted a system of regular wage increases. Regular wage increases can be divided into automatic increases and increases based on merit rating. The majority of Korean enterprises have adopted the former, under which wages are automatically increased according to length of service. Therefore, the result of merit rating is not reflected in the wage increase decision.

their influence. Demands from trade unions for the guarantee of a subsistence allowance led to the emergence of a pay system which puts heavy emphasis on the stability of workers' lives.

Wage levels also underwent a great change. The higher organization rate of trade unions gave outlets to the eruption of workers' dissatisfaction with the low level of wages, and the management gave in to their two-digit wage increase demands. As a result, some companies with no ability to pay went bankrupt because of too high a level of wages.

Rapid changes in the environment of domestic and international markets, for their part, compelled Korean enterprises to strengthen their international competitiveness. Stabilization of wages and improvement of productivity emerged as the main tasks to be dealt with by Korean companies in order to cope with the new atmosphere. The government and companies, recognizing the crisis of fierce international competition, are trying to emplace new wage systems through a shift from wages based on academic level, age, and length of service to those based on a meritocracy which emphasises ability, performance, and contribution. Reflection on the seniority-based pay, prompted by rapid changes in the business environment, led to the introduction of the annual salary system in Korean companies.

Current Status of the Adoption of the Annual Salary System

According to a 1994 survey conducted by the Korea Employers Federation [KEF] on the current status of the introduction of the annual salary system, an extremely small number of companies have adopted the system (KEF, 1994, p. 41). Only 10 companies, that is 4.2 percent of those surveyed, were found to be implementing the system. The annual salary system has been restricted to certain occupations, such as managerial, professional, and technical staff.

Table 2. Adoption of the Annual Salary System in Korean Companies

(Unit: Percent)

Classification	Kind of industries		Total	Size of companies		
	Manufacturing industries	Non-manufacturing industries		Companies with fewer than 300 workers	Companies with 300 to 999 workers	Companies with 1,000 or more workers
Annual salary system not adopted	97.7	91.6	95.8	96.6	95.1	95.8
Annual salary system adopted	2.4	8.5	4.2	3.4	5.0	4.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Korea Employers Federation, 1994.

With regard to standards for deciding the annual salary, five of the above-mentioned 10 companies took into consideration the combined criteria of capability, performance, and attitude, while only one company chose capability or performance as the sole criterion. This means that the annual salary system of Korean companies is not being implemented by taking performance as the main criterion, but rather by adding such new factors as capability and performance to the current wage system.

With regard to increases or decreases in annual salary, half of the companies that

have adopted the system were found not to have decreased salaries, whereas the rest were giving minimum compensation for the positions or qualifications of workers. Ten to 20 percent of salary was indicated as being the appropriate amount for an increase or decrease.

Eight among the 10 companies answered that salary inversion, which means that a subordinate worker's salary becomes larger than that of his superior, is acceptable. A high proportion of workers think that inversion will be inevitable as personnel and wage management systems based on capability are spreading throughout enterprises.

According to a survey on employee attitudes conducted in 1992 by the Korea Employers Federation, for a question regarding annual salary and promotion inversion, 39.5 percent of workers answered that they could accept both, 33.3 percent responded that they could not accept any inversion in wage or rank, 9.9 percent answered that they could not accept reversal in rank, and 17.2 percent said that they could not accept wage inversion (Yang and Ahn, 1993, pp. 341-345). Of special note is the fact that about 40 percent of workers said that inversion in wage or rank is inevitable. This can be attributed to a change of mentality among workers which emphasizes capability rather than seniority.⁴

As 6.6 percent of companies responded that they are planning to adopt the system while 70.3 percent answered that they are considering its adoption, the annual salary system is expected to be introduced into more companies.

On a question asked of companies with positive views about the annual salary system, with regard to which personnel are appropriate for the annual salary system, managerial and professional staff was cited by 46.4% of companies, sales staff by 25.3%, and technical staff by 19.2%. Managerial and professional staff have been chosen as the most appropriate targets for the annual salary system.

As to reasons for planning to adopt the annual salary system, 48.1% of companies responded with 'wage system corresponding to workers' capabilities,' 26.9% said 'motivation for workers with good results,' and 15.4% answered with 'means to secure competent manpower' (KEF, 1994, pp. 45-46).

As to reasons for not planning to adopt the annual salary system, 44.9% of companies answered that a correct evaluation is difficult, 37.8% said that it is too early for the system to be conducted in Korea considering the current general conditions, and 8.3% responded that the system is inappropriate for Korea because of its cultural traditions which emphasize respect for elders (KEF, 1994, p. 47). Consequently, enterprises which take a negative or passive attitude to the adoption of the system seem to consider that objectivity of evaluation, and harmony between the annual salary system and existing personnel or compensation management based on seniority as the most difficult problems.

Some 76.7% of companies expect that the annual salary system will become popular for certain personnel, including managerial or professional staff, while only 18.5% estimate that the system will not be adopted generally as it is just a fad. The system was expected to be widely adopted within the next five years by more than 50% of the responding companies, which shows that these companies regard the general introduction of the system as being quite possible (KEF, 1994, p. 49).

⁴Change of workers' mentality on wages is also indicated in the following studies, Kim (1992) and Chung (1993).

As to some of the most important advantages of the introduction of the annual salary system, 44.0% of companies cited motivational effects, 24% mentioned flexibility of personnel management, and 15% of companies cited facilitated wage management (KEF, 1994, pp. 49-50).

According to a 1995 survey made by the Management Institute of the Pohang Steel Co. (POSCO) on the adoption of the annual salary system (POSCO Management Institute, 1995), 68.4 percent of surveyed workers were for the system and 30.8 percent were against it. The result of the survey showed that the majority of employees, especially younger workers with higher academic levels, preferred the annual salary system.

In contrast to the results of the above-mentioned surveys, only a small minority of companies are adopting the annual salary system. However, the adoption rate of the system in Korean companies is expected to rise considering various factors such as low economic growth, the high level of wages, the aging of the workforce, internationalization, globalization, and changes in workers' mentality.

Case Studies on the Implementation of the Annual Salary System in Korean Companies

This chapter will examine the characteristics of the annual salary system in Korean companies through case studies.⁵

[Case 1] Annual Salary System of the Doosan Group

The Doosan Group, an enterprise with 100 years of tradition, has been making steady growth. The company adopted an annual salary system in 1994, recognizing the need to establish an organizational culture in which capability is given favor in order to transform itself into a top-notch enterprise of the 21st century.

The basic purpose of adopting the system was to exclude personal elements such as age, years of service and academic levels, and to differentiate wages according to individual capabilities or performance. The system is being applied to all managerial staff from the level of division chief up.

Annual salary may be divided into base salary, capability-based pay and performance-related pay. The annual salary is first determined through an evaluation of an individual workers' task-performing abilities and qualifications. A contract is concluded after the sum of the salary has been agreed upon through interviews with managers. The total sum of the annual salary is divided by 12 months and given to the worker once a month.

Individual evaluation to determine annual salary is based on competence and attitude appraisals which are equally applied to every manager in the group. The individual worker's annual salary is differentiated by rank, which is obtained from merit ratings. Rates for the annual salary increase for each rank are as follows: an

Table 3. Table for the Adjustment of the Annual Salary

	A	B	C	D	E
Proportion of workers	5%	10%	70%	10%	5%
Rates for adjusting wage differences	plus 5%	plus 4%	plus 3%	plus 2%	plus 2%

⁵The case studies used are summaries of excerpts from Korea Personnel Management Association (1995).

increment of 5% for A, 4% for B, 3% for C, and one of 2% for D and E. Thus the difference of wage increment between the maximum and minimum is three percent.

As for performance-related pay, which has no relationship to base salary, the method of management by objective is used to evaluate performance for the year and to differentiate the sum of performance-related pay. Increment rates for each group are as follows: an increase of 10% for A, 8% for B, 6% for C, 3% for D, and one of 1% for E.

Table 4. Standards for Performance-Related Pay

	A	B	C	D	E
Proportion of workers	5%	10%	70%	10%	5%
Rates for adjusting wage differences	plus 10%	plus 8%	plus 6%	plus 3%	plus 1%

[Case 2] The Annual Salary System of the Miwon Group

The Miwon Group adopted an annual salary system in 1995. The system is applied to every employee of managerial level in the Group. The annual salary is divided into basic pay and capability-based pay. Workers of the same rank are given the same amount of basic pay, while a different amount of capability-based pay is given according to the results of the merit rating.

In the annual salary system of the Miwon Group, the maximum and minimum of the annual salary are set for different ranks of qualification. As different increase rates are applied to each worker according to the results of the merit rating within each range, each employee's annual salary is different from that of other workers.

Table 5. Pay Structure of Miwon Group According to Different Ranks of Qualification

										A					
										A	B				
										A	B	C			
										A	B	C	D		
										A	B	C	D	E	
										A	B	C	D	E	Rank M1
										A	B	C	D	E	Rank M2
										A	B	C	D	E	Rank M3
										A	B	C	D	E	Rank P1
										B	C	D	E	Rank P2	
										C	D	E	Rank P3		
										D	E	Rank G1			
										E	Rank G2				
										Rank G3					
Pay Band	Performance Evaluation Band														

The reason for dividing each wage range into five stages is to determine the increase rates of capability-based pay by linking the stages with the results of the performance evaluation.

An individual worker's annual salary is determined after consideration of the results of both the performance evaluation and the individual's position in the annual salary pay band. The individual evaluation reflects the results of the performance and capability evaluations by certain rates; the ratio of the former to the latter is about 70 percent to 30 percent, though small differences may be found within each company.

A more specific description of the method to determine the sum of annual salary is as follows. With regard to basic pay, a basic increase rate is applied regardless of the performance evaluation in order to guarantee a minimum subsistence allowance. The increase rate for each worker's capability-based pay is decided by considering his position in the pay band of the annual salary and performance evaluation.

[Case 3] The Annual Salary System of Samsung Data Systems

Samsung Data Systems, a subsidiary of the Samsung Group, is an information service company which develops software for various organizations. It adopted an annual salary system in 1994.

The objective of adopting the system was to secure competent human resources on a regular basis, to motivate workers to exert their full capability, and improve productivity by guaranteeing treatment which corresponds to the capability and performance of professional staff equipped with high technology. For the present, the annual salary system applies to executive officers who develop software. The system will be extended in the future to managerial and sales staff, and to project managers.

Evaluations to calculate annual salary begin in February every year, and the new annual salary is determined in March. When the calculation of the annual salary is completed, a contract is concluded by informing each employee of the amount of his annual salary and the amount of increase, followed by contract signature. A worker can present a complaint about the sum of annual salary only one time. The sum of the annual salary is confidential.

The annual salary table is applied to rank and length of service. The total annual salary is calculated by addition of monthly pay and bonus. Performance-related pay is added according to an evaluation of performance during the year. The annual salary table is updated every year to reflect increases in prices and wages. On the basis of 20 ranks which are decided through an evaluation of capability and performance, capability-based pay is given from a minimum of minus 2.4 million *won* (approximately \$3,000) to a maximum of plus 18 million *won*, while performance-related pay is given from a maximum of plus 400% of bonus to a minimum of minus 100% of bonus.

Evaluations cover capability and performance. The capability evaluation is composed of the following proportions: 40% for merit rating; 40% for evaluation of technical ability; and 20% for the personality evaluation. Chiefs of each business division are responsible for the personality evaluation. For the evaluation of technical ability, each worker reports his technical qualifications according to a table of technology classification. The qualification is confirmed through an evaluation by a team chief and outside experts such as university professors from relevant departments. Technical abilities to be evaluated include those which are common to the entire company, those which are essential to the department, and those which are special to

the individual worker.

The five possible rankings are Excellent (7 points), Very Good (5 points), Good (3 points), Ordinary (2 points), and no points. Technical abilities which are special to individual workers are ranked as Excellent (3 points), Very good (2 points), and Good (1 point). The performance evaluation is exclusively applied to project managers after project completion. Evaluations on the performance of projects are evaluated through criteria such as Meeting the Deadline (20%), Budget (30%), and Level of Customer Satisfaction (50%).

The method of paying the annual salary is identical to that of paying ordinary monthly wages. The total sum of the annual salary is divided into monthly wages and bonus and given every month. Therefore, capability-based pay is divided and paid at the time of giving regular bonuses (June and December), while performance-based pay is given in lump sum after a project is completed.

Evaluation and Problems

Until recently in Korea, a bona fide annual salary system had been applied only in the field of professional baseball. It will not be easy for the annual salary system to be accepted by Korean companies because of the current practice of wage management. Most Korean companies have adopted a Korean version of the annual salary system which harmonizes the elements of seniority, capability and performance. This tendency will remain.

As shown in the above-mentioned KEF survey, more than 70 percent of the companies questioned are considering the adoption of the annual salary system. Taking this proportion into account, the number of companies which adopt the system is bound to increase. However, even in this case, the practice of harmonizing seniority-based pay with the annual salary system will prevail.

For the successful implementation of the annual salary system, the equity of wages guaranteed by fair and objective evaluation should be presupposed. However, it is not an easy task to evaluate the performance of managerial or professional staff in a manner which is sufficiently reliable and valid as to satisfy them. As a matter of fact, many superiors are found to be hesitant to give extreme estimations such as 'excellent' or 'mediocre' when they evaluate workers.

As most workers have a tendency to overestimate their ability to perform a task, they may distrust the result of a wage increase based on a merit rating if it does not come up to their expectation, and even, to some degree, lose the willingness to work.

Therefore, an objective and fair system of merit rating is indispensable if the annual salary system is to have the desired effect. Differences in wage increase rates based on workers' performance should be settled appropriately in order to motivate them, while keeping the proportion of pay that changes according to the merit rating within reasonable limits in the total sum of the annual salary. There should also be clear communication between high level managers and front-line employees with regard to the results of merit ratings and the annual salary decision. In conclusion, it will take a long time for the annual salary system to take root in Korean companies as the corporate culture of seniority and collectivism will be decisive barriers for a system that is based on merit and individualism.

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