5

Understanding Your Internal Labor Market

THE STARTING POINT for a human capital strategy is a clear understanding of the workforce, both what it is today and what it is becoming. Like a living organism, a workforce evolves constantly as new people enter, others leave, and employees acquire new skills and experience. Thus at any moment in time an organization's workforce is the outcome of the following three interrelated labor "flows" and the effectiveness with which they are managed:

- *Attraction*. Who comes into the organization? How successful is the organization at drawing in the kinds of people it needs to achieve its goals?
- *Development*. How do people move through the organization, through different assignments, jobs, and levels of responsibility? How successful is the organization at growing and nurturing the kinds of human capital it needs to execute its business strategy?
- *Retention*. Who is staying and who is leaving? How successful is the organization at retaining people who have the "right" capabilities and produce the highest value?

Attraction, development, and retention interact in a dynamic process that over time determines the characteristics and effectiveness of the workforce. The dynamics are influenced by both management practices and external market conditions. In other words, they operate in an open system. Because that system governs labor transactions *inside* an organization, we call it an internal labor market, drawing on a concept that is well developed in the research literature. We will return to that concept below.

As in any system, changes in one component produce changes in others. For instance, changes in labor market conditions, such as local unemployment rates, typically produce changes in an organization's retention rate, although the degree of change varies from organization to organization. So if labor markets tighten, turnover is likely to rise to some degree as employees take advantage of growing opportunities elsewhere. Changes in retention in turn affect the pace and pattern of hiring as well as the rate at which incumbents are promoted. These outcomes also may affect the ways in which those incumbents develop and the kinds of experiences they acquire in moving from job to job. This chain of events also is influenced by the level and pattern of rewards, which signal the capabilities, behaviors, and attitudes the organization truly values. These affect how employees value the employment relationship, and so on.

The point we are making should be clear. The workforce is always in flux, always in the making. The way a company manages these dynamics determines the kind of workforce it will have and how that workforce will perform.

The Role of Rewards

Rewards play a critical role in a firm's internal labor market dynamics. We use the term *rewards* to mean more than money. Rewards include compensation, benefits, and career-related opportunities and experiences. Understanding how those elements come together to energize internal labor market dynamics is essential to managing them successfully.

Rewards affect more than employees' motivation on the job. They affect *who* is in the workforce: both the kinds of people attracted to the organization and the kinds who stay with it. Rewards also influence the

way human capital develops in an organization. Indeed, rewards and development are linked inextricably. For one thing, development opportunities are rewards in themselves: a form of in-kind payment. Development expands an individual's capabilities and enhances his or her prospects for future earnings. If you doubt the financial significance of this statement, think about how often people take a lower-paying job because of the experience or special training opportunities it provides. Employment in the military is a classic example.

Rewards also influence employees' choices about their learning and development. They signal what an organization ultimately values. Let's recall the manufacturing company discussed in Chapter 1. That company knew that it needed technical specialists to ensure product quality, and it extolled their contributions. However, capable engineers, observing how much farther and faster generalists progressed, could not misconstrue what the company's actions said about its values. They did not need to look at their colleagues' paychecks to learn the truth. They only had to look at where individuals were moving in the career hierarchy. That was why so many tried to get on the generalist development track. The company rewarded generalists, and that was precisely what it got, to its chagrin.

Over time, an organization *becomes* what it rewards. Thus, any attempt to measure and model the dynamics of an internal labor market must include a careful evaluation of the drivers of rewards. Prices and quantities are always linked. Translated to the terms of an internal labor market, this means that rewards (price) and labor flows (quantities) define the system *together*.

Foundations of Internal Labor Market Analysis

Obviously, a necessary step toward managing the dynamic process in the internal labor market is to understand it. At a minimum, that means describing it accurately. Better still, understanding means knowing *why* the internal labor market operates as it does and what the consequences are for an organization.

The dynamic process we have described is complex but not inscrutable. New analytic tools and the wealth of data in modern human resources (HR) information systems make it possible to measure and model these labor flows and rewards, decipher their patterns, iden-

tify the forces that drive them, and gauge their consequences. That knowledge can be used to forecast what the future workforce will look like in response to changes in external conditions or management practices. The knowledge gained also provides the basis for implementing the right measures to track progress toward achieving the most desired internal labor market dynamics.

The analytic tool we've devised for these purposes is the Internal Labor Market (ILM) analysis. The concept of an internal labor market dates back to the 1950s, although the idea was developed most fully in the early 1970s in the work of Peter B. Doeringer and Michael J. Piore. Their seminal book, *Internal Labor Markets and Manpower Analysis*, was concerned with labor transactions within organizations, which those authors tried to characterize and understand.[1]

Doeringer and Piore actually used the term *internal labor market* to describe institutional practices that supplant the external market. Those practices reflect and encourage long-term commitments between the employer and the employee and include, for example, reliance on formal career paths, a tendency to hire only at lower levels within each career path, and the convention of linking pay to jobs within a rigid hierarchy of jobs rather than to the attributes of individual employees. The effect of those practices is largely to insulate an organization from the influences of outside labor markets.

Our use of the term is not limited to a particular organizational form or set of employment practices. Instead, we use it to encompass the entire range of management practices that govern transactions between employer and employee inside the organization. To us, the most important and practical implication of Doeringer and Piore's work is that every organization is running a form of labor market, usually without realizing it. Decisions made by executives affect the efficiency with which that market operates and the results it produces. By managing their internal labor market astutely, executives can shape the workforce to the specifications of the business and leverage human capital investments far more effectively.

In the years since Doeringer and Piore's book was published researchers in economics and organizational psychology have tended to focus on particular aspects of internal labor markets, such as the drivers of turnover and compensation and patterns of response to vacancies created by employees leaving an organization. A vast research literature

has emerged that provides valuable information and insights that can be used to interpret findings about one's own internal labor market dynamics.[2] (See Appendix B.) However, until now no one has provided a *holistic* view of the way internal labor markets operate or characterized the dynamics of this system through the use of a set of integrated statistical models. That is what ILM analysis is all about. It can be used to understand what makes a company's internal labor market tick, the processes by which it creates the company's human capital and applies it to business objectives. That understanding can help leaders manage the microeconomy of their organizations to deliver the workforce and practices their business strategies require.

The three principles of human capital management—system, facts, and value—come together in an ILM analysis. That analysis views an organization and its environment as an interconnected *system*. It uncovers *facts* relevant to decision making and determines where *value* is being created and lost. ILM analysis is systematic in the sense that it looks at the different pieces of the human capital puzzle and the ways they interact. Rather than relying only on employees' and managers' opinions or what company policy manuals state, ILM analysis establishes the facts by observing and measuring critical workforce events and behaviors over extended periods and identifying what drives them. Finally, it concentrates on *value* creation by forecasting how human capital will grow and where value is created.

What Internal Labor Market Analysis Does

ILM analysis provides a fact-based platform for making many essential decisions about human capital. At the most basic level it examines the flow of people into, through, and out of an organization by using HR data and answers fundamental questions about a firm's workforce, including the following:

- Who gets hired?
- Who stays?
- Who advances?
- Who performs well?
- What actually gets rewarded?
- How are rewards distributed?
- How is talent developed?

At a higher level ILM analysis provides critical insights into the operation of the human capital system, reflecting actual practices and their consequences. It focuses on causal links between critical workforce events and behaviors *over time*; thus, it can be used to forecast the effects of specific changes in management practices and market conditions. ILM analysis combines simple descriptive counts and sophisticated statistical modeling techniques that we and our associates have been perfecting through research and work with companies since 1994. It draws on an organization's HR and payroll databases and other relevant sources, including external labor market data. It can be applied to the entire workforce or to particular occupational groups and business segments.

Mapping Human Capital

The point of departure for an ILM analysis is the creation of an *internal labor market map*, a graphic, quantitative picture that describes key dynamics related to the flow of people into, through, and out of an organization over time. The map is a flexible, highly detailed description of the way an organization's internal labor is operating currently. To best understand the current state, of course, it is useful to understand the recent changes that have brought it about; thus, ILM analyses typically capture facts from the preceding three to five years.

The map tallies and displays things such as the average annual number of people entering and leaving an organization at various career levels. It quantifies the movement of people within and between career levels. The map also is used to display where various attributes of human capital—experience, selected skill sets, and so on—are concentrated. An ILM map can do this for the entire organization, for each of its business units or functions, and for different segments of the employee population. In summary, an ILM map provides a concise picture of an organization's human capital.

Every organization has a unique ILM map. Figure 5-1 shows the ILM map for TechCo, the chip-making company whose business problems were introduced in Chapter 2. How does one read such a map? Let's begin with the horizontal bars in the center of the figure. Each bar represents a different career level. Each level clusters a number of jobs and titles and shows the relative proportions of employees at that point in the hierarchy. Those levels are not just markers of salary grades; they

Figure 5-1

TechCo's Internal Labor Market Map
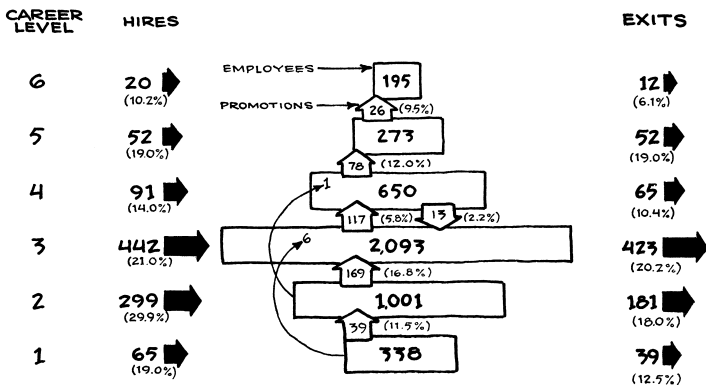
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represent major points of career advancement at which the level of responsibility, authority, scope of job, and pay change fundamentally. The numbers in the horizontal bars represent the number of people in the level.

Now note the arrows between the boxes. Upward-pointing arrows indicate the average annual number of people promoted to the next higher level during the period, with fast-track promotions shown by arrows that skip a level. The numbers next to each upward arrow show the associated probability of promotion. Downward-pointing arrows indicate the rare instances of demotions. For example, on average 15 people were demoted from level 4 to 3. Some of the demotions are performance-related, and some are the product of negotiated arrangements between employer and employee, such as helping employees make the transition to retirement or deal with pressing issues of work-family balance.

The left-hand column of arrows in the map indicates the number of people entering at each level per year. Those average numbers also are expressed as a percentage of the total employees in their respective career levels. The number of individuals (and percentages) leaving the company from each level per year are shown in the right-hand column of arrows and numbers.

All calculations for an ILM map must be based on a consistent unit

of time, such as a year, to be meaningful. Maps, however, can be constructed for shorter or longer periods, depending on the organization's needs. The map in Figure 5-1 is only one example of the kinds of facts that can be displayed. Other maps might highlight the number and rates of lateral moves within a career level. Still others might represent the proportions of employees at each level by employee segment, such as gender or high-potential standing. Maps like the one in Figure 5-1 are flexible and accommodating to each organization's circumstances and needs.

ILM maps come in a number of different shapes (see the sidebar following). Obviously, the shape reveals how hierarchical an organization is and how employees are spread throughout the organization. It also indicates something about the likely role of career advancement in the overall reward structure of the organization. By looking at patterns of entry and promotion throughout the hierarchy, one can tell whether an organization is prone to buy or build its talent. Build-from-within organizations tend to limit hiring at the middle and upper levels in order to concentrate on the development of homegrown talent and keep promotion opportunities for incumbents strong. A proportionately large number of middle-level hires is inimical to both objectives.

Finally, the pattern of entry and exit can indicate something about the organization's sensitivity to changes in outside labor market conditions. Doeringer and Piore note that in some organizations inflows and outflows of employees are concentrated at certain levels only, what they call "ports" of entry and exit. These are touch points with the marketplace where the company has the greatest exposure to outside influences.

Organizations that build talent from within might have the most entry points at certain lower levels and exit patterns that are more diffuse. Organizations that tend to buy talent have many touch points with the market, as evidenced by diffuse patterns of entry and exit. In a build-from-within organization, reward systems may be hierarchical as well, strongly linked to job level and/or length of service. Hence, employees are locked quickly into the organization as the cost of leaving becomes prohibitive. This creates a degree of insulation from the outside labor market. Indeed, changes in labor market conditions have little or no impact on turnover for a build-from-within firm. The advantage is more stability in the workforce and greater opportunities to invest in people and build firm-specific human capital. The disadvantage is loss of flexi-

bility and a distancing from market realities. This can be especially hazardous at times of fundamental change in competitive conditions.

The Story Behind the TechCo Map

What specifically can be learned from the TechCo map shown in Figure 5-1? Quite a bit. First, it can be seen that the employee population bulges near the middle. Highly hierarchical companies are shaped like pyramids, with a handful of people at the top and more and more people filling each lower career level. This is true of TechCo within the leadership levels of the organization, levels 4 and above, but not below.

- The map reveals a large population (of engineers) congregated in level 3. Level 3 is a career bottleneck or "choke point." As the percentages associated with the upward arrows indicate, employees at levels 1 and 2 have a high probability of promotion. The probability of moving beyond level 3 in a particular period (a year in this case), however, is low: 5.8 percent. It is even lower for engineers.
- Level 3 employees are leaving in large numbers. On average, almost 20 percent of employees at this level left the organization each year during the period in question.
- TechCo's hiring practices are at odds with the need for firm-specific knowledge. How does the analyst know this? The ILM map indicates that the largest number of outside hires occurred at level 3, but a substantial percentage of new hires were coming into the management ranks at levels 4 and 5. By definition, those individuals arrived without the firm-specific knowledge, on which the company depends. Clearly the company is not developing its managerial talent from within.

Beyond Description: Modeling Internal Labor Market Dynamics

Maps are the foundation of the ILM analysis, but they are only the beginning. Far more revealing are the facts unearthed through statistical modeling of the dynamic process behind a map. It is the statistical modeling that reveals *how* and *why* internal labor markets actually work. This is where the true human capital story of an organization emerges,

and with it the detail every organization needs to manage its internal labor market successfully. Let's see how the analysis is done.

ILM analysis consists of an integrated set of core statistical models that cover the following areas:

- Drivers of turnover
- Drivers of promotion
- Drivers of lateral movement
- Drivers of compensation, usually pay levels and pay growth
- Drivers of individual performance

These models often are supplemented by an analysis of the patterns of entry to determine what kinds of people are joining the organization, which recruitment sources are utilized most intensively, and which are most effective in delivering the right kinds of people. The analysis also can show how successfully an organization is tapping external labor markets whether those markets are defined geographically or occupationally. Other models, such as the determinants of incentive compensation, sometimes are created and tested to fit an organization's specific situation.

Modeling is all about understanding causes and consequences in a constantly changing system. The analyst wants to see how management practices and employee attributes bring about the movements, events, and changes observed in a company's internal labor market. Modeling also is about priorities. We want to identify which of the many potential causes (rewards, selection, etc.) of key events (quitting, career success, etc.) are the most important drivers of those events so that managers can prioritize actions to address problems. Deciphering causes and consequences requires an examination of system dynamics over time. It also requires the ability to account for competing influences.

The statistical models in an ILM analysis have a certain symmetry in that they rely on a common set of independent (or predictor) variables and statistical controls that fall into three categories:

- *Employee attributes*—indicators of demographic and job-related characteristics measured at the individual level. These include age, gender, race, education, job, credentials, and labor market experience, and performance history, among other things.

- *Organizational attributes and practices*—characteristics of the immediate environment in which an employee works and the management practices that affect those measures. These attributes include measures such as the size and heterogeneity of a department or work group, the turnover rate within the group, the manager's span of control, and workload, to name a few.
- *External influences*—characteristics of the market environment in which the facility operates, including local unemployment rates, product or service market share, and location. These influences often function as statistical controls in the models.

Clues from Map Shapes

One can learn a lot about a company by looking at the shape of its ILM map. Maps with a clear pyramid shape indicate a strong hierarchical situation. The majority of employees occupy the lower job levels, and populations fall precipitously as one moves up the pyramid, along with opportunities for advancement. Other companies have maps with more of a diamond shape, such as TechCo, with employees clustering in the middle layers. In those organizations populations tend to be more homogeneous, at least in terms of occupation. Still others have more of a block shape, with employees distributed more or less evenly across levels. In these cases those at the top are still actively involved in the "production process" and are not focused exclusively on managing functions and other employees. Professional services firms sometimes have this structure.

Figure 5-2

Sample Map Shapes

PYRAMID   DIAMOND   BLOCK
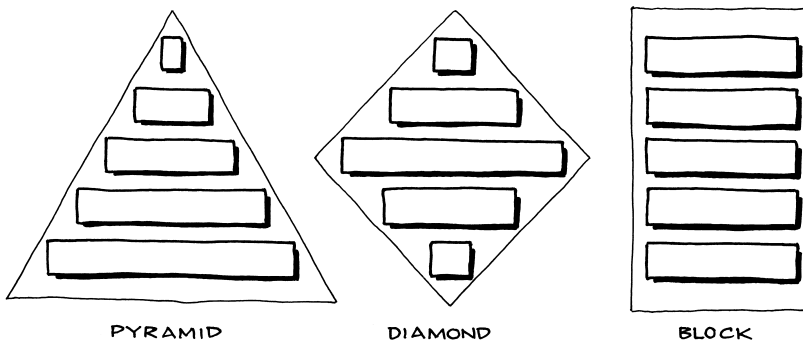
The statistical models that make up ILM analysis produce an account of what drives the dynamic flows that characterize internal labor markets. A core turnover model, for instance, would provide an

estimate of how factors such as an employee's length of service in the firm and educational attainment, to name just two, affect the likelihood that that employee will leave in a particular year, all else being equal. The promotion model might provide an estimate of how an employee's performance rating or past performance history affects that employee's chance of being promoted in a particular period after accounting for all the other relevant factors (e.g., job, operating unit, identity of supervisor). The compensation models can be used to assess the extent to which changing labor market conditions influence pay levels of both incumbents and new hires or to measure differences in total compensation for those with different specializations. The models together provide a rich and comprehensive picture of the kinds of human capital the organization is securing and valuing. (See Appendix B for models.)

It also is possible to measure the way different causal factors work together. One might hypothesize, for instance, that all else being equal, the effect of unemployment rates on turnover is greater among technically skilled employees. One can test whether this holds true within a specific workforce. If the data support the hypothesis, one can say that an interaction exists between technical skill and unemployment rates; that is, the impact of unemployment rates on a company's workforce depends on the employee segment (in this case, employees are segmented according to technical skills). Knowledge of these interdependencies can prevent an organization from wasting resources on one-size-fits-all solutions and help it direct interventions to the areas where they are most needed. That knowledge can even help a company detect complementarities between management practices that can be exploited to increase the impact of a particular intervention.

In summary, ILM analysis not only describes but also explains. By isolating the attributes or circumstances associated with employee movements and experiences through modeling, the tool delivers the unvarnished facts that executives need to make good decisions about the people side of their businesses.

Case Illustration: MoneyCo

Let's examine some outputs from the ILM models and see how the results from ILM analysis come together to shed light on an organization's internal labor market. We'll use the case of an organization we

call MoneyCo, a financial services organization with operations in several regions of the United States. Its core business serves a specialized segment of the financial market. Many of its competitors offer almost identical products and services.

MoneyCo competes on service quality and to some extent on price. Financial results indicated that MoneyCo was not faring well on either dimension. However, upon its acquisition by a larger regional bank, MoneyCo sought to expand its range of services and exploit linkages with its parent company, including opportunities for cross-selling. This represented a significant shift in its business strategy.

Difficult times had forced MoneyCo to go through several rounds of layoffs, a shakeup in the senior management team, and reorganization. Those dislocations had produced an unstable workforce and weakened its management system. The chief executive officer (CEO) recognized these problems and knew that MoneyCo had to tend to its human capital if it hoped to succeed.

The executive team agreed that certain human capital requirements were paramount. To avail themselves of cross-selling opportunities, they would need a workforce that could play more of an advisory than a purely selling role. That workforce had to be customer-focused and equipped with excellent relationship-building skills. In addition, customer-facing employees would need expertise in a full range of products and services, both those of their own company and those of their parent, and have the perceptiveness and discipline to match them to customer needs. This combination of capabilities could neither be created overnight nor "bought." It represented firm-specific human capital that could only be built from within. Finally, the company would need to expand its workforce's ability to support a broadening of its product portfolio.

An ILM analysis was conducted to determine whether MoneyCo's internal labor market as it was managed currently would produce the workforce needed to achieve the company's objectives. Some key results of our analysis of rewards at MoneyCo are summarized in Figure 5-3.

The grid shown in the figure—a key output of ILM Analysis—represents the combined results of statistical modeling of the drivers of (1) promotion, (2) year-to-year pay growth, and (3) pay levels at MoneyCo. It encapsulates what the organization *actually* rewards. It identifies the factors (individual, organizational, and environmental) associated with

Figure 5-3

MoneyCo's Rewards
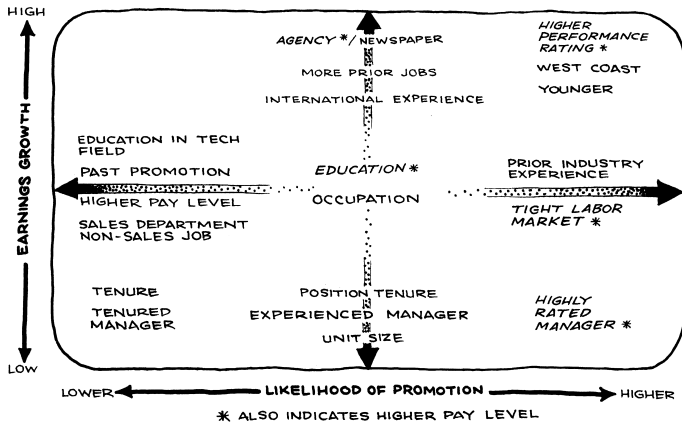
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individual success in a particular company. At the individual level it is a success profile. Viewed from the organizational perspective, it is something of a culture map, representing the characteristics that the organization most values in its employees as evidenced by actual reward patterns. Yes, there is more to organizational culture than rewards, but the grid provides insight into aspects of an organization that strongly influence its culture.

Here is how to read this rewards grid. Promotion likelihood is on the horizontal axis; annual pay growth is on the vertical axis. Italicized factors are associated with higher pay levels. The center of the grid, where the lines cross, is the origin. Factors near the origin add nothing to the probability that an employee will be promoted in the next year and do not influence pay increases.

Consider these examples. In the upper-right-hand corner one sees "higher performance ratings" in italics. This indicates that all else being equal, an individual with a higher performance rating is more likely to be promoted, is experiencing larger pay growth, and tends to be more highly paid overall. In other words, when one compares like people in like jobs and like locations, those rated higher tend to do better across all the reward dimensions than do their lower-rated counterparts. Thus, MoneyCo's performance management and rewards systems

clearly differentiated employees according to individual performance. Because of the way work was structured at MoneyCo, that seemed to be a good thing. It would encourage high performers without obstructing the cooperation required for cross-selling and referral activity. And it would encourage high performers to stay.

Now let's look at the elements in the center of the grid. Note that "education" is located there, in italics. This means that education contributed positively to pay levels. That finding is not surprising. Employers typically recognize the increase in human capital that arises from an increase in education and reward it with higher pay, and MoneyCo was no exception. To hire someone with a higher degree, it had to pay more. Note, however, that education contributed nothing to the other components of rewards. All else being equal, annual pay growth was not higher for the more educated employees, and neither was the likelihood of promotion. In other words, once employed, those with higher degrees were not doing any better than were their less-educated counterparts.

There are two possible interpretations of this finding. The first suggests inappropriate matching of workforce capabilities to company needs. Perhaps formal education did not contribute incremental value to the firm even though it increased the market value of the individual employee. Because of the nature of this business, other factors not associated with educational attainment may have outweighed education: people skills, experience, selling skills, even street smarts. We've encountered this phenomenon many times before. The second explanation is that the current rewards and performance management systems were failing to recognize the real value attributable to education. Either because of the way more educated employees were utilized or because of the failure of supervisors to evaluate performance properly, the more educated people were not getting their due. How could the company expect to keep those people if it failed to value them?

The CEO of MoneyCo didn't care which of these explanations was accurate. He wanted a more educated workforce. He and his team were convinced that the ability of the workforce to take on an advisory role, match products and customers, and build productive relationships with the parent company was enhanced by education. "Yes, perhaps it was true in the past that an individual's performance had little to do with what degree that person had," he said. "But that won't be the case under

our new business model. We really need more educated employees. I want to see education take its place alongside individual performance as something we value in this company. Let's make this happen!"

A final observation concerns MoneyCo's rewards grid. Note that length of service (tenure) is in the lower left corner. Simply put, it had a negative impact on all the dimensions of rewards we measured. A negative relationship with pay *growth* and promotion came as no surprise. It is known from labor economics that although pay typically grows over an employee's work life, its rate of growth begins to decline on average when the individual reaches his or her late thirties. Tenure is not the same as age, and depending on the organization's human capital strategy and the way it structures rewards, the observed relationship between pay growth and tenure can vary. In most cases, however, it follows a trajectory similar to that of the pay-age relationship. That is what we have observed in the vast majority of organizations for which we have done this kind of work.

This negative relationship between length of service and pay *levels* is rare. It usually occurs when companies hire aggressively in tight labor markets, something MoneyCo was doing. Those companies pay such a high premium to new entrants that they end up devaluing their incumbent employees. The "return to tenure," as it is called, declines, sometimes even turning negative. In these cases an additional year of service in the company is worth less than a year working outside it. Apparently, employees at MoneyCo caught on to this.

Greater clarity about this problem emerged when we looked at the results from the analysis of turnover. The results, based on drivers of turnover over a five-year period, are depicted in the bar chart shown in Figure 5-4 where stronger drivers have longer bars.

One thing to note right away is that MoneyCo was extremely vulnerable to conditions in the external labor market. A one-point change in unemployment rates in its geographic areas of operation was associated with at least a four-point change in annual turnover, all else being equal. This was high by any standard, higher than what we've seen in most organizations for which we've estimated this relationship. This was the case for two reasons. One, already discussed, is that the value of employment at MoneyCo was at or below market alternatives, and so employees were quick to leave as outside opportunities increased. The

Figure 5-4

Turnover Drivers At MoneyCo

PERCENTAGE-POINT REDUCTION IN TURNOVER
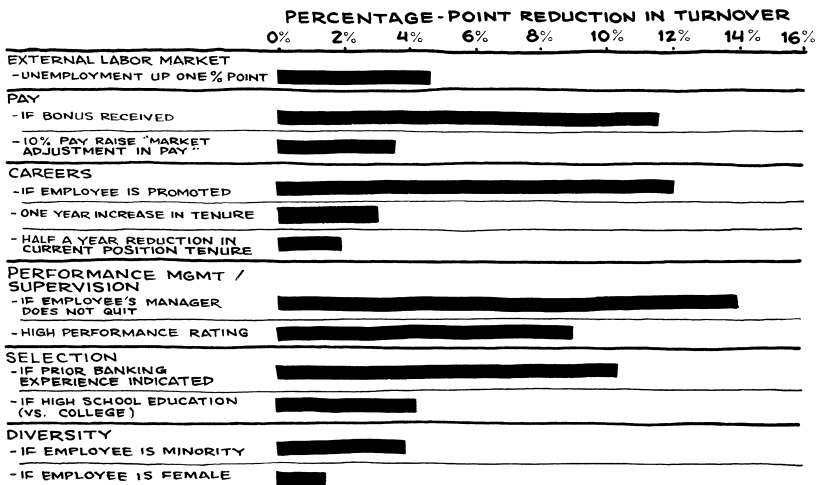
other is that there was little or no "backloading" of rewards at Mon-eyCo, no glue to bind employees to the company for the long term. Many organizations backload rewards by tying certain benefits to length of service. In others backloading is achieved through the carrot of valuable advancement opportunities. The mere prospect of signifi-cant financial rewards—if they are credible—encourages employees to forgo other opportunities and stay with the organization. Neither of these incentives was at work within MoneyCo.

This pattern would not have been a problem if the company's busi-ness strategy required mostly general human capital, but it didn't. Its strategy depended on firm-specific knowledge and experience, which was undermined by MoneyCo's exceptional vulnerability to labor mar-ket forces. That vulnerability was reinforced by what we learned about the retention effects of compensation at the company compared with longer-term career rewards.

It can be seen in the bar chart that MoneyCo's employees were highly responsive to short-term incentive compensation. Employees who received it were about half as likely to leave the company as those who did not, all else being equal. They clearly responded to money. Employees also were responsive to promotion and the trajectory of pay.

At first blush that might suggest that MoneyCo employees had a strong career orientation after all. A deeper look, however, cast doubt on that interpretation. The effect of promotion was shown to dissipate very quickly. Only a promotion within the year reduced the likelihood of turnover, and the same thing was true of past pay increases. Employees seemed to respond only to the most recent pay actions, not to how they were faring over the longer haul. It seemed as if employees looked on promotion not as a meaningful career event but simply as MoneyCo's mechanism for delivering more money.

The company had established a "show me the money" culture, and that had created a serious danger. Unless MoneyCo's financial performance improved quickly, it would be unable to enhance its pay position relative to the market for the incumbent workforce. New hires, whose pay levels better reflected market rates, would continue to outpace longer-term employees, eroding the value of service with the company. If that pattern held, how could the company retain its seasoned, high-performing employees? How would it develop the firm-specific skills that its business strategy required?

The turnover drivers chart shows that those with more years of service were more likely to stay, a behavior we have observed in most companies we have analyzed. However, while directionally correct, the effect was notably small and disappeared after three years with the company.

The analysis confirmed another critical vulnerability: Employees with only a high school education were significantly more likely to stay than were similarly situated employees with a college degree. The more educated employees deemed essential to the new business strategy were walking out. This was by no means a problem unique to MoneyCo: The educated generally have more opportunities and often are more mobile. However, some organizations are able to retain them more readily than others can. The way they utilize and reward those employees is often the key. In light of what we learned about rewards at MoneyCo, was it any wonder that they were leaving at significantly higher rates?

The findings we have revealed here paint a dismal picture, but not everything in MoneyCo's human capital system was misaligned. The rewards and performance management systems appeared to differenti-

ate well between high performers and low performers. Voluntary turnover was much higher among low performers than among those who performed well. Employees with the industry experience needed to enhance MoneyCo's product/service portfolio and expand its customer base were both rewarded and retained. Also, the company had avoided reward disparities for women and minorities, an outcome that supported management's diversity goals.

Still, the ILM analysis revealed that MoneyCo's human capital strategy was not fully aligned with its business needs and market environment. That analysis helped the CEO and his team get a handle on the company's internal labor market, both where it was and where it was heading. Because it quantified the critical dimensions of the workforce situation, management could more easily prioritize its agenda for change. On that basis, MoneyCo developed a new human capital strategy that aimed to achieve the following:

- Reduce its vulnerability to external labor markets
- Restore a credible career structure
- Align rewards, performance management, and supervisory practices with new human capital priorities
- Adjust recruitment and selection criteria to better match the required workforce profile
- Improve retention among employees with critical experience and skills

The tactics used to advance MoneyCo's agenda were selected on the basis of modeling results that allowed the company to prioritize actions and forecast effects. The ILM analysis also positioned the company to create a scorecard of metrics for tracking changes in key components of its internal labor market, assuring accountability for results. Those actions set the company on the road toward building the workforce it needed.

The Value of ILM for Looking Ahead

ILM analysis helps an organization understand both what its workforce is now and what it is becoming. Thus it offers the foundation needed

for effective workforce planning that is capable of supporting business strategy, a point we examine more closely in the next chapter.

ILM analysis can be used to simulate the effects of alternative strategies for achieving desired ends. A particularly powerful application of ILM analysis for looking forward is in the area of workforce diversity. Many organizations have formal diversity programs designed to achieve an appropriate level of representation of women and minority group members. Hiring often is seen as a quick way to meet diversity goals. However, this tactic may or may not produce a sustainable solution. The interrelated influences of hiring, development, promotion, retention, and pay that are unique to each organization ultimately determine a company's success in achieving workforce diversity. In other words, a company's internal labor market needs to be geared to support those objectives.

The facts learned through ILM analysis inform a company's choices about how best to meet its diversity goals. For example, a company may find that it has inadequate representation of women and minorities at middle or upper management levels. One solution to this shortcoming is to increase hiring directly into those levels. An alternative is to increase hiring into the jobs and levels that prepare individuals to perform successfully at the middle and upper levels, that is, to improve the pipeline of candidates.

Which solution or combination of practices is most effective depends on the ILM patterns. It may be that what is most important is the innate ability and market experience of individuals—general human capital—and so hiring directly into areas of deficiency is the appropriate solution. However, if firm-specific experience is critical to success, strategies focused on building the pipeline may over time be more effective and financially sound. After all, if the job candidates hired lack this institutional knowledge, they will be less likely to perform well and more likely to leave. The company will do all the right things in hiring and still be left without the diverse workforce it seeks, and the investments made will yield little or no return.

Companies used to guess about these things, but that is no longer necessary. Using ILM analysis, they can measure employees' responsiveness to different factors, such as rewards, internal mobility, and career development programs. These quantitative measures make it

possible to project into the future to identify the quickest, surest, least expensive ways of meeting longer-term human capital objectives, such as those related to diversity. This analytic tool also reveals the right measures to track and tells managers when to make course corrections as conditions change.

ILM analysis is critical to understanding current workforce dynamics and projecting what workforces can become. Finding methods to determine what the workforce *should be* is the subject of the next chapter.

Key Points

- An organization's workforce is the outcome of a dynamic process that involves the attraction, development, and retention of employees. That process takes place within the internal labor market of the organization and is influenced by both management practices and external market conditions.
- The starting point for a human capital strategy is a clear understanding of an organization's workforce: both what it is today and what it is becoming. Internal Labor Market (ILM) analysis is the key to that understanding. It brings together the three principles of human capital management: systems thinking, facts, and value.
- The concept of the internal labor market expressed in this book encompasses the entire range of management practices that govern transactions between employer and employees inside the organization. Every organization is running a form of labor market, usually without realizing it. By managing the dynamics of their internal labor markets astutely, organizations can shape their workforces to meet the needs of the business and optimize performance.
- The internal labor market map is a foundation output of ILM analysis. It describes key dynamics related to the flow of people into, through, and out of the organization over time in graphic form.
- ILM analysis provides a fact-based platform for making decisions about human capital. It examines the flow of people into,
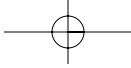
through, and out of an organization and the drivers of those movements. In so doing, it answers fundamental questions about a firm's workforce, such as who is hired and who advances. It is forward-looking, allowing organizations to simulate the effects of alternative strategies for achieving desired ends. Statistical modeling makes all of this possible.