CHAPTER 8
DESIGNING PAY LEVELS, MIX AND PAY STRUCTURES

LEARNING OBJECTIVES

1. Identify the major decisions in establishing externally competitive pay.

2. Describe the purpose(s) of a salary survey.

3. Discuss the importance of defining the relevant market in a pay survey.

4. Explain the steps involved in designing a pay survey.

5. Describe the key issues involved in interpreting the results of a pay survey.

6. Explain how the market pay line combines the internal structure with external market rates.

7. Discuss the use of pay grades and pay ranges and their relationship to internal alignment and external competitiveness.

8. Discuss the pros and cons of the market pricing approach to establishing a pay structure.

OUTLINE

I. MAJOR DECISIONS

A. There are seven major decisions involved in setting externally competitive pay and designing the corresponding pay structures

   1. specifying employer's external/competitive pay policy
   2. define the purpose of the survey
   3. select the relevant market competitors
   4. designing and conducting surveys
   5. interpreting survey results and constructing the market line
6. constructing a pay policy line that reflects the external pay policy
7. balancing competitiveness with internal alignment through the use of ranges, flat rates, and/or bands

**Definition:** A *survey* is the systematic process of collecting and making judgments about the compensation paid by other employers

**Steps in conducting wage and salary surveys:**

1. select the jobs to be surveyed
2. define the relevant markets
3. select the firms to be surveyed
4. determine the information to ask
5. determine the data collection technique
6. administer the survey

**II. SPECIFY COMPETITIVE PAY POLICY**

- an external pay policy requires information on the external market
- surveys provide the data for translating that policy into pay levels, pay mix & pay structures

**III. THE PURPOSE OF A SURVEY?**

A. Conducting a salary survey is necessary to obtain data to set an organization’s pay policy relative to its competitors.

B. An employer conducts/participates in a survey for the following reasons

- its an opportunity to collect information to make judgments regarding compensation
- to adjust pay to changing external pay rates & recognize pay trends in marketplace
- to establish/develop or price an adequate pay structure
- to analyze personnel problems that may be pay related
- defending pay practices in a court of law
• to attempt to estimate the labor costs of product market competitors
• hiring and retaining competent employees
• promoting worker productivity

C. Adjust Pay Level – How Much to Pay?

market surveys provide information so that an employer will be able to adjust the firm's pay levels relative to competitors (ex. AACSB salary survey)

1. most organizations make adjustments to employees’ pay on a regular basis

2. these adjustments can be based on one, or more, of the following issues:

   a. overall upward movement of pay rates caused by competition for people in the market.
   b. performance.
   c. ability to pay.
   d. terms specified in a contract.

D. Adjust Pay Mix – What Forms?

1. the mix of forms and their relative importance makes up the “pay package”

2. adjustments to the different forms that competitors use (base, bonus, benefits, etc) & the relative importance they place on each form occur less frequently than adjustments to overall pay level

3. it is unclear why changes to the pay mix occur less frequently than changes in the pay level

4. since some pay forms may affect employee behavior more than others, collecting information on total compensation, the mix of pay competitors use, and costs of various forms is increasingly important

E. Adjust Pay Structure

survey information used for directly valuing jobs in some cases
in other instances, used to validate job evaluation results (see if market
rates vary greatly from those obtained in the firm’s job evaluation)

F. Study Special Situations

1. information used to review competitor pay scales in case of high turnover
or to justify differentials between certain gender dominated jobs in legal
situations

2. many special studies appraise the starting salary offers or current pay
practices for targeted groups, such as patent attorneys, sales managers, or
software engineers

G. Estimate Competitors’ Labor Costs

1. surveys allow for organizations to compare labor costs especially in a
highly competitive industry, as input for decisions making, etc.

2. they may use salary survey data to benchmark against
competitors’ product pricing and manufacturing practices

IV. SELECT RELEVANT MARKET COMPETITORS

A. To make decisions about pay level, mix, and structures, a
relevant labor market must be defined that includes
employers who compete in one or more of the following
areas

Relevant markets are expressed as:

- employers who compete for the same occupations and skills required
- the geographic distance employees are willing to commute/relocate
- employers who compete with the same products/services

B. As the importance and complexity of qualifications increase,
the geographic limits also increase

C. Competition tends to be national or international for
managerial and professional skills and local or regional for
clerical and production skills

D. The generalizations do not always hold true.
Examples include:

1. in areas with high concentrations of scientists, engineers, and managers, the primary market comparison may be regional, with national data used only secondarily

2. some larger firms ignore local market conditions

E. Research suggests that if skills are tied to a particular industry, as underwriters, actuaries, and claims representatives are to insurance, the market should be defined on an industry basis

1. if certain skills, i.e. accounting, sales, clerical, are not limited to one particular industry, then industry considerations are less important.

2. from the perspective of cost control and ability to pay, competitors in the product/service market should be included since the pay rates of these competitors will affect both an employer’s costs of operations and its financial condition.

F. While the quantity of data available for international comparisons is improving, using the data to adjust pay requires a lot of judgment.

G. **Fuzzy Markets**

1. new organizations and jobs fuse together diverse knowledge and experience, so “relevant” markets appear more like “fuzzy” markets

2. organizations with unique jobs and structures face the double bind of finding it hard to get comparable market data at the same time they are placing more emphasis on external market data

**V. Design the Survey**

A. Consulting firms offer a wide variety of surveys covering almost every job family and industry group imaginable.
B. Survey design involves considering the following issues:

1. Who should be involved in the survey design?
2. How many employers should be included?
3. Which jobs should be included?
4. What information should be collected?

C. Whom to Involve?

- compensation specialist or HRM manager
- operating managers
- employees (task managers)
  - outside consultants (avoid wage fixing allegations)

D. How Many Employers?

- depends on circumstances, no set/magic numbers (problematic for global companies)
- in small markets with few employers: 2 or 3 firms
- in larger local markets with 200-300 positions: 12-24 firms
- in national labor market and some regional survey: 100+ firms
- salary surveys reflect industry, geographical area

Publicly Available Data

a. The Bureau of Labor Statistics is the major source of publicly available compensation data and publishes extensive information on various occupations in different geographic areas
b. While some private sector firms may track the rate of change in BLS data as a cross-check on other surveys, the data are not specific enough to be used alone

“Word-of-Mouse”

a. A click of the mouse makes a wealth of data available to
everyone and means that managers must be able to explain the salaries paid to employees compared to those a mouse-click away.

b. The quality of salary data on the Web is highly suspect.

**Where Are the Standards?**

a. Opinions about the value of consultant surveys are rampant

b. Many firms select one survey as their primary source and use others to cross-check of validate the results

c. Some firms routinely combine the results of several surveys and weight each survey in a composite based on a judgment of the quality of the data reported

d. For staffing decisions, employment test designers report the test’s performance against a set of standards (reliability, validity, etc.)
For market surveys and analysis, similar indices and standards do not exist

**E. Which Jobs to Include?**

Keep the survey simple and include only enough jobs necessary to accomplish the purpose of the survey and to encourage participation

1. Benchmark Jobs Approach

   • include only benchmark (stable in content) jobs in the surveys
   • ensure that benchmark jobs represent all function/levels in the firm
   • slotting of remaining jobs

2. Low-High Approach

   • useful for skills based structure that has no match with competitors
   • identify highest and lowest paid benchmark jobs for the relevant skills and use these as anchors for skills based structures
   • slot the remaining wage rates into the structure

3. Benchmark Conversion Approach

   • traditional approach
   • perform job evaluation on all jobs and use benchmarks on survey
   • transfer salary info from benchmark jobs & convert internal
F. What Information to Collect?

Collect information about:

- the nature of the organization (size, structure, financial)
- information about the total compensation system (bonus, benefit)
- actual rates paid to each incumbent for jobs included in survey

No survey includes all the data included in the discussion; the data collected depend on the purpose of the survey.

**Organization Data** – data includes company identification, financial information, size of company, and the structure of the organization.

**Total Compensation Data**

- all the basic types of pay forms are required to assess the total pay package and competitors’ practices
- data collected includes:
  1. *Base pay* – amount of cash competitors decided each job and incumbent is worth.
  2. *Total cash* – includes base plus bonus; indicates competitors’ use of performance-based cash payments.
  3. *Total compensation* – includes total cash plus stock options and benefits

VI. INTERPRET SURVEY RESULTS & CONSTRUCT A MARKET LINE

There is no single best approach that is used to analyze data. There are steps that the organization should take to ensure that use of the information is justified.

A. Verify Data

- test for quality & accuracy of data (examine distribution patterns)
- check for accuracy of job matches (titles vs. descriptions)
- if jobs are similar but not identical, then leveling can be used to weight
data according to closeness of match

B. Anomalies

1. perusing actual salary data provides an analyst with a sense of the quality of the data and helps identify any areas for additional consideration.
2. anomalies may include:
   (1) does any one company dominate?
   (2) do all employers show similar patterns?
   (3) outliers?
3. analysis of the anomalies may indicate additional information about competitors’ pay policies, ex. a competitor may deliberately differentiate itself with pay as part of its strategy

C. Statistical Analysis

- frequency distribution (organizes data into intervals)
- central tendency (mean, mode, median, weighted means)
- dispersion (get some idea from mean and dispersion value, the distribution of wages; ex. standard deviation, quartiles/percentiles)
- outliers/extreme values can distort mean value
- using this information to establish a single wage value

D. Update the Survey Data

- to counteract "aging" of data, adjusts need to be made

Extent of updating depends on:

- historical trends in the marketplace
- economic outlook for the future in the employer's market
- consumer price index (CPI)
- manager's judgement

E. Construct a Market Pay Line

Development of a market pay line involves making decisions about which benchmark jobs to include, which companies to include, and which measures of pay to use
• usually a straight line but can be curvilinear or hinged
• statistical techniques such as regression analysis can be used to derive a market pay line
• pay level policy will reflect positioning of pay line (percentile)

**Definition:** A market line links a company’s benchmark jobs on the horizontal axis (internal structure) with market rates paid by competitors (market survey) on the vertical axis. It summarizes the distribution of going rates paid by competitors in the market.

F. Combine Internal Structure and External Wage Rates

The internal consistency and external competitiveness components of the pay model are combined through the development of the pay structure.

The pay structure achieves two objectives:

- produces pay policy line to reflect market wages to internal structure
- allows for pay ranges, and give the firm some internal flexibility

VII. FROM POLICY TO PRACTICE: THE PAY POLICY LINE

A. The pay policy line reflects external competitive position in the market

B. There are several ways to translate external competitive policy into practice

1. **Choice of measure** – based on Colgate’s stated policy, Colgate would use the 50th percentile for base pay and the 75th percentile for total compensation as compensation measures in its regression

2. **Updating** – the approach used by an organization to update salary survey data reflects its pay policy.

C. **Policy Line as Percent of Market Line.**

1. another way to translate pay-level policy into practice is to simple specify a percent above or below the regression line (market line) that an employer intends to match and
then draw a new line at this higher (or lower) level

2. there are alternatives among competitive pay policies, and there are alternative ways to translate policy into practice

3. if the practice does not match the policy, then employees receive the wrong message

VIII. FROM POLICY TO PRACTICE: GRADES AND RANGES

Creating pay ranges is also part of designing a pay structure that reflects the organization’s policies on maintaining internal alignment and external competitiveness

A. Why Bother with Grades and Ranges?

1. grades and ranges offer flexibility to deal with pressures from external markets and differences among organizations
   - quality differences among jobholders
   - productivity differences among individuals
   - differences in the mix of pay forms competitors use

2. ranges provide managers the opportunity to:
   - recognize individual performance differences with pay
   - meet employee expectations that pay will increase with time
   - encourage employees to remain with organization

3. from an internal alignment perspective a range reflects differences in:
   - performance
   - experience

4. from an external competitiveness perspective, a range is a control device

5. ranges are not used by all employers
   - skill-based plans establish single rates for each skill level regardless of performance or seniority
   - flat rates are favored by unions (use regression formula)
   - broad bands are being adopted for greater flexibility
B. Develop Grades

- fairly similar jobs (comparable value) are grouped together
- lateral moves without change in pay
- allows for certain degree of flexibility
- some subjective decisions in designing pay grades makes it tough
- jobs grouped together for traditional purposes, career pathing

C. Establish Ranges Midpoints, Minimums, and Maximums

- midpoint of each range serves as control point to correspond with
- the pay policy line following a matching(competitive) policy
- midpoint reflects pay level at which competent person is paid
- range spreads vary according to jobs (spread increasing with worth)
- determine degree of overlap desired (arithmetic, geometric, random)

D. What Size Should the Range Be?

a. size of the range is based on judgment about how the ranges support career paths, promotions, and other organization systems.
   (1) top-level management positions typically have ranges of 30 to 60% above and below the midpoint
   (2) entry to mid-level professional and managerial positions typically have ranges of 15 to 30% above and below the midpoint
   (3) office and production work typically have ranges of 5 to 30% above and below the midpoint

b. compensation managers use actual survey rates, particularly the 75th and 25th percentiles, as the range minimums and maximums

c. another approach is to establish the minimum and maximum separately, with the amount between the minimum and the midpoint a function of how long it takes a new employee to become fully competent

E. Overlap (re: rules of thumb)

- degree of overlap to mirror commonality between grades
- high degree of overlap indicate small differences in the value of jobs in
adjoining grades – ex. title change but not much change in pay
• overlap beyond three adjacent grades should be avoided
• jumps in pay grade should involve at least 10% differential
• size of differentials should support career movement thru’ structure
• difference between supervisor and worker: approx. 1 grade or 15%

IX. FROM POLICY TO PRACTICE: BROAD BANDING

A. Broad banding is a new technique

1. this approach consolidates approximately 4 – 5 traditional pay grades into a single band with one minimum and one maximum

2. since a band encompasses many jobs of differing values, a range midpoint is usually not specified

B. Contrasts between ranges and broad bands are highlighted in Exhibit 8.19

C. Supporters of broad bands list several advantages:

1. they provide flexibility to define job responsibilities more broadly

2. they support redesigned, downsized, or boundary-less organizations that have eliminated layers of managerial jobs

3. they foster cross-functional growth and development.

   a. employees can move laterally across functions within a band to gain depth of experience

   b. emphasis on lateral movement with no pay adjustments helps manage the reality of fewer promotions in flattened organizational structures

4. flexibility eases mergers and acquisitions since there are not a lot of levels to argue over

D. The most important difference between the grades and ranges and broad-banding approaches is the location of controls
1. grade and range approach has guidelines and controls designed into the pay system

2. band approach has only a total salary budget that provides constraints.

E. Banding involves two steps:

1. **Set the number of bands**
   
   a. examples indicate the use of 5 to 6 bands for pay purposes
      
      (1) Merck uses 6 bands for its entire pay structure
      (2) General Electric replaced 24 levels of work with 5 bands
   
   b. the challenge is how much to pay employees who are in the same band but different functions performing different work

2. **Price the bands and reference market rates**
   
   a. each band will likely include multiple job families.
   
   b. based on external market differences in pay rates, the different functions within each band are likely to be priced differently

   - collapsing several traditional grades into one or two career bands
   - objective is to provide more flexibility in moving people among jobs
   - don’t need to change band or make pay adjustment when moved

**Steps**

1. Set number of bands – usually three to eight for pay purposes.
2. Price bands using reference market rates and zones
3. Determine within band (lateral) movement since purpose of banding is to encourage cross-functional movement

**X. BALANCING INTERNAL AND EXTERNAL PRESSURES:**
**ADJUSTING THE PAY STRUCTURE**
A. Adjustments may be necessary in the pay structure to balance internal consistency and external competitiveness.

B. A distinction has been made between the job structure and the pay structure

1. A job structure orders jobs on the basis of internal organizational factors that are reflected in job evaluation or skill/competency certification

2. A pay structure is anchored by an organization’s external competitive position and reflected in its pay-policy line

C. Reconciling Differences

- Internal JE & external market survey results may not agree and may therefore produce two different structures
- pay structure vs. job structure (ex. labor shortage may impact this)
- review of the JA and JE may be necessary to see if a job was accurately evaluated or to a/c for differences between market rate & internal rate
- managers tend to weigh market data more heavily than internal J.E.

D. Locality Pay

- problems with governmental transfers (NYC vs. Des Moines)
- GS system makes no allowance for performance factor
- federal government pay system less sensitive to market changes
- Federal Employee Pay Comparability Act of 1990 (FEPCA)

E. Compression

- caused by pressure of external forces vs. internal factors
- outside wages increasing faster than internal ones
- pay differential among jobs are smaller relative to KSA differences

XI. MARKET PRICING

- strong emphasis on market de-emphasizes internal consistency.
- price as many jobs as possible in external market, then rank to mark the unique jobs
- appropriate for firms with lots of jobs comparable to external market
• down side is that it allows competitors (market) set pay policy

XI. YOUR TURN: Word-Of-Mouse: Dot-Com Compensation Comparisons

YOUR TURN 2: Are Compensation Surveys Upward Biased?