CHAPTER 13
Compensation Strategies and Practices

After you have read this chapter, you should be able to:

- Identify the two general types of compensation and the components of each.
- Give examples of two different compensation philosophies in organizations.
- Discuss four strategic compensation design issues currently being used.
- Describe three behavioral considerations affecting compensation activities.
- Identify the basic provisions of the Fair Labor Standards Act (FLSA).
- Define job evaluation and discuss four methods of performing it.
- Outline the process of building a wage and salary administration system.
- Discuss how a pay-for-performance system is established.
Compensation systems in organizations must be linked to organizational objectives and strategies, as the opening discussion of Bayer Corporation indicates. But compensation also requires balancing the interests and costs of the employer with the expectations of employees. A compensation program in an organization should have four objectives:

- Legal compliance with all appropriate laws and regulations
- Cost effectiveness for the organization
- Internal, external, and individual equity for employees
- Performance enhancement for the organization

For employers, compensation costs must be at a level that both ensures organizational competitiveness and provides sufficient rewards to employees for their knowledge, skills, abilities, and performance accomplishments. Balancing these facets so that the employer can attract, retain, and reward the performance of employees requires considering several types of compensation.

**Nature of Compensation**

Compensation is an important factor affecting how and why people choose to work at one organization over others. Employers must be reasonably competitive with several types of compensation in order to hire, keep, and reward performance of individuals in the organization.

**Types of Compensation**

Rewards can be both *intrinsic* and *extrinsic*. *Intrinsic* rewards often include praise for completing a project or meeting some performance objectives. Other psychological and social effects of compensation reflect the intrinsic type of rewards. *Extrinsic* rewards are tangible, having the form of both monetary and nonmonetary rewards. Tangible components of a compensation program are of two general types (Figure 13–1). With the direct type of compensation, monetary rewards are provided by the employer. *Base pay* and *variable pay* are the most common forms of direct compensation. Indirect compensation commonly consists of employee benefits.

**Base pay** The basic compensation an employee receives, usually as a wage or salary.

**Wages** Payments directly calculated on the amount of time worked.

**Salaries** Payments that are consistent from period to period despite the number of hours worked.
switched to an all-salaried approach with their manufacturing and clerical employees in order to create a greater sense of loyalty and organizational commitment. But they still must pay overtime to certain employees in jobs covered by federal and state pay laws.

**VARIABLE PAY** Another type of direct pay is **variable pay**, which is compensation linked directly to performance accomplishments. The most common types of variable pay for most employees are bonuses and incentive program payments. For executives, it is common to have longer-term rewards such as stock options. Variable pay, including executive compensation, is discussed in Chapter 14.

**BENEFITS** Many organizations provide numerous extrinsic rewards in an indirect manner. With indirect compensation, employees receive the tangible value of the rewards without receiving the actual cash. A **benefit** is an indirect reward, such as health insurance, vacation pay, or retirement pensions, given to an employee or group of employees as a part of organizational membership.

**Compensation Responsibilities**

Compensation costs are significant expenditures in most organizations. For instance, at one large hotel, employee payroll and benefits expenditures comprise about 50% of all costs. Although compensation costs are relatively easy to calculate, the value derived by employers and employees is more difficult to identify. To administer these expenditures wisely, HR specialists and other managers must work together.

A typical division of compensation responsibilities is illustrated in Figure 13–2. HR specialists usually guide the overall development and administration of an organizational compensation system by conducting job evaluations and wage surveys. Also, because of the technical complexity involved, HR specialists typically are the ones who develop base pay programs and salary structures and policies. Operating managers evaluate the performance of employees and consider

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**FIGURE 13–1 Components of a Compensation Program**

**DIRECT**
- **Base Pay**
  - Wages
  - Salaries
- **Variable Pay**
  - Bonuses
  - Incentives
  - Stock options

**INDIRECT**
- **Benefits**
  - Medical insurance
  - Paid time off
  - Retirement pensions
  - Workers’ compensation

**Variable pay** Compensation linked to individual, team, and/or organizational performance.

**Benefit** An indirect reward given to an employee or group of employees as a part of organizational membership.
that performance when deciding compensation increases within the policies and guidelines established by the HR unit.

**Strategic Compensation**

Compensation decisions must be viewed strategically. Because so many organizational funds are spent on compensation-related activities, it is critical for top management and HR executives to view the “strategic” fit of compensation with the strategies and objectives of the organization. The changes in the global marketplace for products and services have led to organizational changes in business philosophies, strategies, and objectives. Increasingly, organizations are recognizing that compensation philosophies must change also. The example of Bayer Corporation illustrates this alignment. The compensation practices that typically exist in a new organization may be different from those in a mature, bureaucratic organization. For example, if a firm wishes to create an innovative, entrepreneurial culture, it may offer bonuses and stock equity programs so that employees can participate in the growth and success of the company, but set its base pay and benefits at relatively modest levels. However, for a large, stable organization, highly structured pay and benefit programs may be more common.

**Compensation Philosophies**

There are two basic compensation philosophies, which should be seen as opposite ends of a continuum. At one end of the continuum in Figure 13–3 is the entitlement philosophy; at the other end, the performance-oriented philosophy.

**ENTITLEMENT ORIENTATION** The entitlement philosophy can be seen in many organizations that traditionally have given automatic increases to their employees every year. Further, most of those employees receive the same or nearly the same percentage increase each year. Employees and managers who subscribe to the entitlement philosophy believe that individuals who have worked another year are entitled to a raise in base pay, and that all incentives and benefit programs should continue and be increased, regardless of changing industry or economic conditions. Commonly, in organizations following an entitlement philosophy, pay increases are referred to as cost-of-living raises, whether or not they are tied specifically to economic indicators. Following an entitlement
philosophy ultimately means that as employees continue their employment lives, employer costs increase, regardless of employee performance or other organizational competitive pressures. Market comparisons tend to be made within an industry, rather than more broadly considering compensation in firms of all types. Bonuses in many entitlement-oriented organizations are determined very paternalistically and often do not reflect operating results. Instead, the CEO or owner acts as Santa Claus at the end of the year, passing out bonus checks that generally do not vary from year to year. Therefore employees “expect” to receive the bonuses as another form of entitlement.

**PERFORMANCE ORIENTATION** Where a *performance-oriented* philosophy is followed, no one is guaranteed compensation just for adding another year to organizational service. Instead, pay and incentives are based on performance differences among employees. Employees who perform well get larger compensation increases; those who do not perform satisfactorily receive little or no increase in compensation. Thus, employees who perform satisfactorily should keep up or advance in relation to a broad view of the labor market for their jobs, whereas poor or marginal performers should fall behind.

Bonuses are paid based on individual, group, and/or organizational performance results. Few organizations are totally performance-oriented in all facets of their compensation practices. However, breaking the entitlement mode is increasingly occurring in the organizational restructuring common throughout many industries. A study of public-sector HR managers found that there is a desire and need to shift toward more performance-oriented compensation practices in many public-sector organizations. How fast that occurs, given the historical traditions and the strength of public-sector unions, remains to be seen.

**Strategic Compensation Design**

Designing a compensation system for an organization requires knowledge of the strategic issues facing the organization and the culture of the organization. Organizations today are facing more pressures and greater demands for flexibility from their managers and employees. As Figure 13–4 on the next page notes, compensation strategies used in organizations have shifted. Organizations that are more static have fixed salaries, limited participation in bonuses, and other features clearly focused internally. However, dynamic, rapidly changing organizations have more varied compensation systems that reward current performance and growth.
It is critical that organizations align their compensation practices with their organizational cultures, especially if efforts are made to change the cultures because of competitive pressures. For instance, a telecommunications firm faced major changes in the industry after government restrictions on pricing were removed and cable television firms were allowed to provide telephone service. The firm could not continue to offer the wages it had paid when government agencies allowed the pricing of services to obtain full cost recovery and a set level of profits. When changing organizational culture, organizations must change their compensation systems if they are to avoid sending mixed signals to employees. The opening discussion about Bayer Corporation illustrates the importance of matching compensation practices to the organizational culture.

Another strategic design consideration for compensation systems is to balance the costs of attracting and retaining employees with the competitive pressures in its industry. Considering these pressures is particularly important when the organization faces a very tight labor market for workers with specific skills. The cost pressures of industry competition with organizations in lower-wage countries such as China or Mexico must also be addressed, while maintaining competitive pricing for the firm’s products and services.

Some organizations have specifically stated policies about where they wish to be positioned in the labor market. These policies use a quartile strategy, and Figure 13–5 illustrates the three different quartiles. Data in pay surveys reveals that the actual dollar difference between quartiles is generally 15–20%.

Most employers position themselves in the second quartile, in the middle of the market, based on pay survey data of other employers’ compensation plans.
Choosing this level attempts to balance employer cost pressures and the need to attract and retain employees by mid-level compensation plans.

An employer using a first-quartile approach is choosing to pay below market compensation. This may be done for several reasons. One is because of a shortage of funds and the inability to pay more and still meet strategic objectives. Also, if there is an abundance of workers, particularly those with lower skills, then a below-market approach can be used to attract sufficient workers at a lesser cost. The downside of this strategy is that higher turnover of workers is more likely. If the labor market supply tightens, then difficulty in attracting and retaining workers will probably result.

A third-quartile approach is an aggressive, above-market emphasis. This strategy may be chosen to ensure that sufficient workers with the required capabilities are attracted and retained. It also may allow the organization to be more selective when hiring workers. However, because it is a higher-cost approach, it is crucial that those paid above-market wages be more productive.

Most compensation programs are designed to reward employees for the tasks, duties, and responsibilities performed. It is the jobs done that determine, to a large extent, which employees have higher base rates than others. Employees are paid more for doing jobs that require more variety of tasks, more knowledge and skills, greater physical effort, or more demanding working conditions.

**COMPETENCY-BASED PAY** However, as discussed in Chapter 7 on job analysis, some organizations are emphasizing competencies more than tasks. A growing number of organizations, including Bayer Corporation, are paying employees for the competencies they have rather than just for the specific tasks being performed. Paying for competencies rewards employees who are more versatile and have continued to develop their competencies. In knowledge-based pay (KBP) or

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**FIGURE 13-5 Compensation Quartile Strategies**

<table>
<thead>
<tr>
<th>Quartile</th>
<th>Strategy</th>
<th>Percentages</th>
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</thead>
<tbody>
<tr>
<td>Third Quartile</td>
<td>Above-Market Strategy</td>
<td>(25% of firms pay above and 75% pay below)</td>
</tr>
<tr>
<td>Second Quartile</td>
<td>Middle-Market Strategy</td>
<td>(50% of firms pay above and 50% pay below)</td>
</tr>
<tr>
<td>First Quartile</td>
<td>Below-Market Strategy</td>
<td>(75% of firms pay above and 25% pay below)</td>
</tr>
</tbody>
</table>
skill-based pay (SBP) systems, employees start at a base level of pay and receive increases as they learn to do other jobs or gain other skills and therefore become more valuable to the employer. For example, a printing firm has two-color, four-color, and six-color presses. The more colors, the more skill required of the press operators. Under a KBP or SBP system, press operators increase their pay as they learn how to operate the more complex presses, even though sometimes they may be running only two-color jobs. The HR Perspective describes research on such a plan.

A survey sponsored by the American Compensation Association (ACA) found that the success of competency plans requires managerial commitment to a philosophy different from the one that has existed traditionally in organizations. This approach places far more emphasis on training employees and supervisors. Also, workflow must be adapted to allow workers to move from job to job as needed.

When an organization moves to a competency-based system, considerable time must be spent identifying what the required competencies are for various jobs. Then each block of competencies must be priced using market data. Progression of employees must be possible, and they must be paid appropriately for all of their competencies. Any limitations on the numbers of people who can acquire more competencies should be clearly identified. Training in the appropriate competencies is particularly critical. Also important to a competency-based system is a means for certification of employees who have acquired certain competencies. Further, a process must exist for verifying that employees maintain competencies. In summary, use of a competency-based system requires significant investment of management time and needs a continuous commitment by top management.
Because competency plans focus on growth and development of employee competencies, those employees who continue to develop their competencies to receive pay raises are the real winners. As more organizations recognize the value of human resources, it is likely that competency-based systems may spread.

**Broadbanding and Career Development** Using an approach closely related to competency-based compensation, many organizations have revised their hierarchical pay structures. Broadbanding, which uses fewer pay grades having broader ranges than traditional compensation systems, is increasingly being used. Figure 13-6 depicts the difference between traditional pay structures and broadbanding. Interest in broadbanding also has spread globally. One survey of global companies found increased usage of broadbanding and career bands in 15 different countries.7

There are several reasons why it is beneficial to reduce the number of pay grades and broaden pay ranges. First and foremost, broadbanding is more consistent with the flattening of organizational levels and the growing use of jobs that are multidimensional. With fewer bands and broader ranges, employees can

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**FIGURE 13-6 Traditional Pay Structure vs. Broadbanding**

<table>
<thead>
<tr>
<th>TRADITIONAL PAY STRUCTURE</th>
<th>BROADBANDING</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,000 3</td>
<td>$30,000</td>
</tr>
<tr>
<td>$43,000 4</td>
<td>Max $56,000</td>
</tr>
<tr>
<td>$49,000 5</td>
<td>$40,000</td>
</tr>
<tr>
<td>$56,000 5</td>
<td></td>
</tr>
</tbody>
</table>

**Broadbanding**

Practice of using fewer pay grades having broader ranges than traditional compensation systems.

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Both the organization and employees can benefit from a competency-based system that is properly designed and implemented. Some outcomes are:

**Organization-Related Outcomes**
- Greater workforce flexibility
- Increased effectiveness of work teams
- Fewer bottlenecks in workflow
- Increased worker output per hour

**Employee-Related Outcomes**
- Enhanced employee understanding of organizational “big picture”
- Greater employee self-management capabilities
- Improved employee satisfaction
- Greater employee commitment
shift responsibilities as market conditions and organizational needs change. Traditional questions from employees about when a promotion to a new grade occurs, and what pay adjustments will be made for temporarily performing some new job responsibilities, are unnecessary.8

Another advantage of broadbanding is that employee career development can be enhanced when the artificial barriers of numerous pay grades are removed. With broadbanding, many of the control mechanisms traditionally enforced by HR departments also are removed, and authority for more compensation decisions is decentralized to the operating managers. By allowing employees to move into other job areas and broaden their knowledge, skills, and abilities without having to deal with a large number of constraints imposed by a compensation program, the organization encourages employees to move between departments, divisions, and locations. In firms that have adopted broadbanding, employees are encouraged to move across business units and apply for openings in areas of the company other than where they have been working. This cross-functional development is beneficial because it creates more employees who have greater flexibility and broader sets of capabilities. One study of companies using broadbanding found that the primary reasons for its use were (1) creating more flexible organizations, (2) encouraging competency development, and (3) emphasizing career development.9

However, broadbanding is not appropriate for every organization. Many organizations still operate in a relatively structured manner, and the flexibility associated with broadbanding is not consistent with the traditional hierarchal culture in which executives and managers have been operating.

Another problem with broadbanding is that many employees have become “conditioned” to the idea that a promotion is accompanied by a pay raise and movement to a new pay grade. As a result of removing this grade progression, the organization may be seen as having fewer upward promotion opportunities. Furthermore, a number of individuals do not want to move across the organization into other areas.

Despite these and other problems, it is likely that broadbanding will continue to grow in usage. As more and more organizations face changes due to competition and other strategic factors, the flexibility of broadbanding may be needed.10

**BASE AND VARIABLE PAY** Another growing compensation approach is the use of variable pay throughout the organization. Traditionally in many organizations, most employees receive compensation based either on wages or salaries. Except for executives, few individuals receive additional pay tied to performance except for annual raises in their base pay amounts.

Currently, variable pay programs have been extensively adopted throughout many organizations and for all levels of employees. Widespread use of various incentive plans, team bonuses, organizational gainsharing programs, and other designs have been implemented in order to link growth in compensation to results. Management must address two main issues when using variable pay systems:

- Should performance be measured and rewarded based on individual, group, or organizational performance?
- Should the length of time for measuring performance be short-term (less than one year) or longer-term (more than one year)?

The various types and facets of variable pay are discussed in the next chapter. But it is important to monitor the shift toward compensation being allocated
through such plans, rather than the organization relying solely on base pay to reward employees at all levels for attaining strategic organizational objectives.

TEAM-BASED COMPENSATION Another compensation design issue that has grown in importance is team-based compensation. As organizations have shifted to using work teams, a logical concern is how to develop compensation programs that build on the team concept. It becomes even trickier because organizations are compensating individuals who work in teams. Paying everyone on teams the same amount even though there are differing competencies and levels of performance obviously may create equity concerns for individual employees.

Many organizations use team rewards as variable pay above base pay. For base pay, individuals are compensated using competency- or skill-based approaches. A study of organizations using team-based rewards, and of individuals serving on the teams, identified that team rewards are most frequently distributed annually (58%) as a specified dollar amount (56%), not as a percentage of base pay (44%).

Based on experiences in the team-based environment, as the HR Perspective illustrates, several factors should be considered when using team-based reward systems:

- Use skill-based pay for the base.
- Make the system simple and understandable.
- Use variable pay based on business entity performance.
- Distribute rewards at the team level.
- Have a high degree of employee involvement.
In summary, the most successful uses of team-based compensation have been as variable pay on top of base pay. Rather than substituting for base pay programs, team-based rewards appear to be useful in rewarding performance of a team beyond the satisfactory level. More discussion on team-based incentives is contained in the next chapter.

Behavioral Aspects of Compensation

Behavioral factors affect all types of compensation. Most people in work organizations are working in order to gain rewards for their efforts. Except in volunteer organizations, people expect to receive fair value in the form of compensation for their efforts. Whether regarding base pay, variable pay, or benefits, the extent to which employees perceive they are receiving fair value often affects their performance and how they view their jobs and employers.

Equity

People want to be treated fairly in all facets of compensation, including base pay, incentives, and benefits. This is the concept of equity, which is the perceived fairness of the relation between what a person does (inputs) and what the person receives (outcomes). Inputs are what a person brings to the organization and includes educational level, age, experience, productivity, and other skills or efforts. What a person receives from the organization, or outcomes, are the rewards obtained in exchange for inputs. Outcomes include pay, benefits, recognition, achievement, prestige, and any tangible or intangible reward received. Individuals judge equity in compensation by comparing the effort and performance they give with the effort and performance of others and the rewards those others receive. But it must be stressed that these comparisons are personal and based on individual perceptions, not just facts.

A sense of inequity occurs when the comparison process results in an imbalance between input and outcomes. As Figure 13–7 indicates, there are individual, organizational, and external dimensions to equity.

PROCEDURAL AND DISTRIBUTIVE JUSTICE IN COMPENSATION

Internally, equity means that employees receive compensation in relation to the knowledge, skills, and abilities (KSAs) they use in their jobs as well as their responsibilities and accomplishments. Two key issues that relate to internal equity are procedural justice and distributive justice.

Procedural justice is the perceived fairness of the process and procedures used to make decisions about employees, including their pay. Procedural fairness is viewed both in terms of the policies and procedures and the actions of supervisors and managers who implement the policies and procedures. As it applies to compensation, the process of determining the base pay for jobs, the allocation of pay increases, and the measurement of performance must be perceived as fair. Two critical issues are (1) how appropriate and fair is the process used to assign jobs to pay grades? and (2) how are the pay ranges for those jobs established?

Another related issue that must be considered is distributive justice, which refers to the perceived fairness of the amounts given for performance. This facet of equity refers to how pay relates to performance. For instance, if a hard-working employee whose performance is outstanding receives the same across-the-board raise as an employee with attendance problems and mediocre perfor-
significantly more flexibility in determining pay levels and policies. Unionized employees usually have their pay set according to the terms of a collective bargaining contract between their employer and the union that represents them. Because pay is a visible issue, it is natural for unions to emphasize pay levels.

According to U.S. Bureau of Labor Statistics data, employers having unionized employees generally provide higher wage levels than nonunion employers. The strength and extent of unionization in an industry and in an organization affect wage levels. The levels generally are higher in firms in heavily unionized industries with highly unionized workforces. As union strength in heavily unionized industries has declined, pay increases on a percentage basis for union employees have diminished somewhat in recent years; in many areas, they have lagged those of nonunion employees.

**Development of a Base Pay System**

Once pay policies have been determined, the actual development of a base pay system begins. Because most organizations use task-based systems focusing on work done in specific jobs, that is the emphasis of this discussion. If skill-based or team pay systems are used, then many of the activities discussed here must be modified.

As Figure 13–11 shows, the development of a wage and salary system assumes that accurate job descriptions and job specifications are available. The job
descriptions then are used in two activities: job evaluation and pay surveys. These activities are designed to ensure that the pay system is both internally equitable and externally competitive. The data compiled in these two activities are used to design pay structures, including pay grades and minimum-to-maximum pay ranges. After the pay structures have been developed, individual jobs must be placed in the appropriate pay grades and employees’ pay adjusted based on length of service and performance. Finally, the pay system must be monitored and updated.

**Job Evaluation**

Job evaluation provides a systematic basis for determining the relative worth of jobs within an organization. It flows from the job analysis process and is based on job descriptions and job specifications. In a job evaluation, every job in an organization is examined and ultimately priced according to the following features:

- Relative importance of the job
- Knowledge, skills, and abilities (KSAs) needed to perform the job
- Difficulty of the job

It is important that employees perceive their pay as appropriate in relation to pay for jobs performed by others. Because jobs may vary widely in an organization, it is particularly important to identify benchmark jobs—jobs that are found in many other organizations and are performed by several individuals who have similar duties that are relatively stable and that require similar KSAs. For example, benchmark jobs commonly used in clerical/office situations are accounts payable processor, word processing operator, and receptionist. Benchmark jobs are used with all of the job evaluation methods discussed here because they provide “anchors” against which unique jobs can be evaluated.

Several methods are used to determine internal job worth through job evaluation. All methods have the same general objective, but they differ in complexity and means of measurement. Regardless of the method used, the intent is to develop a usable, measurable, and realistic system to determine compensation in an organization.

**RANKING METHOD** The ranking method is one of the simplest methods of job evaluation. It places jobs in order, ranging from highest to lowest in value to the organization. The entire job is considered rather than the individual components. Several different methods of ranking are available, but all present problems.

Ranking methods are extremely subjective, and managers may have difficulty explaining why one job is ranked higher than another to employees whose pay is affected by these rankings. When there are a large number of jobs, the ranking method also can be awkward and unwieldy. Therefore, the ranking method is more appropriate in a small organization having relatively few jobs.

**CLASSIFICATION METHOD** In the classification method of job evaluation, descriptions of each class of jobs are written, and then each job in the organization is put into a grade according to the class description it matches the best.

The major difficulty with the classification method is that subjective judgments are needed to develop the class descriptions and to place jobs accurately in them. With a wide variety of jobs and generally written class descriptions, some jobs may appear to fall into two or three different grades.

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**Job evaluation**
The systematic determination of the relative worth of jobs within an organization.

**Benchmark job**
Job found in many organizations and performed by several individuals who have similar duties that are relatively stable and require similar KSAs.
Another problem with the classification method is that it relies heavily on job titles and duties and assumes that they are similar from one organization to another. For these reasons, many federal, state, and local government entities, which traditionally used the classification method, have shifted to point systems.

**POINT METHOD** The point method, the most widely used job evaluation method, is more sophisticated than the ranking and classification methods. It breaks down jobs into various compensable factors and places weights, or points, on them. A **compensable factor** is one used to identify a job value that is commonly present throughout a group of jobs. The factors are determined from the job analysis. For example, for jobs in warehouse and manufacturing settings, physical demands, hazards encountered, and working environment may be identified as factors and weighted heavily. However, in most office and clerical jobs, those factors are of little importance. Consequently, the compensable factors used and the weights assigned must reflect the nature of the job under study and the changes in it.21

Figure 13–12 helps to illustrate how the system is used. The individual using the point chart in the figure looks at a job description and identifies the degree to which each element is necessary to perform the job satisfactorily. For example, the points assigned for a payroll clerk for education might be 42 points, third degree. To reduce subjectivity, such determinations often are made by a group of people familiar with the jobs. Once points have been identified for all factors, the total points for the payroll clerk job are computed. After point totals have been determined for all jobs, the jobs are grouped together into pay grades.

A special type of point method used by a consulting firm, the Hay Group, has received widespread application, although it is most often used with exempt employees. The **Hay system** uses three factors and numerically measures the degree to which each of these factors is required in each job. The three factors and their sub-factors are as follows:22

<table>
<thead>
<tr>
<th><strong>Know-How</strong></th>
<th><strong>Problem Solving</strong></th>
<th><strong>Accountability</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Functional expertise</td>
<td>Environment</td>
<td>Freedom to act</td>
</tr>
<tr>
<td>Managerial skills</td>
<td>Challenge</td>
<td>Impact of end results</td>
</tr>
<tr>
<td>Human relations</td>
<td></td>
<td>Magnitude</td>
</tr>
</tbody>
</table>

The point method has grown in popularity for several reasons. It is a relatively simple system to use. It considers the components of a job rather than the total job and is much more comprehensive than either the ranking or classification method. Once points have been determined and a job evaluation point manual has been developed, the method can be used easily by people who are not specialists. The system can be understood by managers and employees, which gives it a definite advantage.

Another reason for the widespread use of the point method is that it evaluates the components of a job and determines total points before the current pay structure is considered. In this way, an employer can assess relative worth instead of relying on past patterns of worth.

One major drawback to the point method is the time needed to develop a system. For this reason, employers often use manuals and systems developed by management consultants or other organizations. Point systems have also been criticized for reinforcing traditional organizational structures and job rigidity.
same job worth. While there are no set rules to be used in establishing pay grades, some overall suggestions have been made. Generally, from 11 to 17 grades are used in small companies. However, as discussed earlier, a growing number of employers are reducing the number of grades by broadbanding.

By using pay grades, management can develop a coordinated pay system without having to determine a separate pay rate for each job in the organization. All the jobs within a grade have the same range of pay regardless of points. As discussed previously, the factor-comparison method of job evaluation uses monetary values, so an employer using that method can easily establish and price pay grades. A vital part of the classification method is developing grades. Organizations that use the ranking method can group several ranks to create pay grades.

**PAY RANGES** The pay range for each pay grade also must be established. Using the market line as a starting point, the employer can determine maximum and minimum pay levels for each pay grade by making the market line the midpoint line of the new pay structure. (See Figure 13–14.) For example, in a particular pay grade, the maximum value may be 20% above the midpoint and the minimum value 20% below it.
As Figure 13–15 shows, a smaller minimum-to-maximum range should be used for lower-level jobs than for higher-level jobs, primarily because employees in lower-level jobs tend to stay in them for shorter periods of time and have greater promotion possibilities. For example, a clerk-typist might advance to the position of secretary or word processing operator. In contrast, a design engineer likely would have fewer possibilities for upward movement in an organization. This “expanding” approach also recognizes that individual performance can vary more greatly among people in upper-level jobs than in lower-level jobs. However, using the same percentage range at all levels can make administration of a pay system easier in small firms. If broadbanding is used, then much wider ranges, often exceeding 100%, may be used.

Experts recommend having overlap between grades, as in Figure 13–16 on the next page. This structure means that an experienced employee in a lower grade can be paid more than a less-experienced employee in a job in the next pay grade.

Once pay grades and ranges have been computed, then the current pay of employees must be compared to the draft ranges. If a significant number of employees are out of range, then a revision of the pay grades and ranges may need to be computed. Also, once costing and budgeting scenarios are run in order

![Figure 13-14 Pay Scattergram](image)

![Figure 13-15 Typical Pay Range Widths](table)

<table>
<thead>
<tr>
<th>Types of Jobs</th>
<th>Range Above Minimum</th>
<th>% Around Midpoint</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executives</td>
<td>50%–70%</td>
<td>± 20–25%</td>
</tr>
<tr>
<td>Mid Management/Professionals</td>
<td>40%–50%</td>
<td>± 16–20%</td>
</tr>
<tr>
<td>Technicians/Skilled Craft &amp; Clerical</td>
<td>30%–40%</td>
<td>± 13–16%</td>
</tr>
<tr>
<td>General Clerical/Others</td>
<td>25%–35%</td>
<td>± 11–15%</td>
</tr>
</tbody>
</table>
to see the financial input of the new pay structures, then pay policy decisions about market positioning may have to be revised. As a result, changes to the pay ranges may lead to lowering or raising the ranges.

**Individual Pay**

Once managers have determined pay ranges, they can set the specific pay for individuals. Each dot on the graph in Figure 13–16 represents an individual
employee’s current pay in relation to the pay ranges that have been developed. Setting a range for each pay grade gives flexibility by allowing individuals to progress within a grade instead of having to be moved to a new grade each time they receive a raise. A pay range also allows managers to reward the better-performing employees while maintaining the integrity of the pay system.

### Rates Out of Range

Regardless of how well constructed a pay structure is, there usually are a few individuals whose pay is lower than the minimum or higher than the maximum. These situations occur most frequently when firms that have had an informal pay system develop a new, more formalized one.

**RED-CIRCLED EMPLOYEES** A red-circled job is shown on the graph in Figure 13–16. A red-circled employee is an incumbent who is paid above the range set for the job. For example, assume that an employee's current pay is $10.92 per hour but the pay range for that grade is between $6.94 and $10.06. The person would be red circled, and attempts would be made over a period of time to bring the employee’s rate into grade. Typically, the red-circled job is filled by a longer-service employee who has declined promotions or has been viewed as unpromotable due to insufficient education or other capabilities. Yet the individual may have continued to receive large pay increases.

Several approaches can be used to bring a red-circled person’s pay into line. Although the fastest way would be to cut the employee's pay, that approach is not recommended and is seldom used. Instead, the employee's pay may be frozen until the pay range can be adjusted upward to get the employee's pay rate back into the grade. The employee can also be transferred to a job with a higher grade or given more responsibilities. This method will result in greater job evaluation worth, thus justifying the job’s being upgraded. Another approach is to give the employee a small lump-sum payment but not adjust the pay rate when others are given raises.

**GREEN-CIRCLED EMPLOYEES** An individual whose pay is below the range is a green-circled employee. Promotion is a major cause of this situation. Assume someone receives a promotion that significantly increases his or her responsibilities and pay grade. Typical promotion adjustments are 8% to 15%, but such an adjustment may still leave the individual below the minimum of the new pay range. Because the promotion represents such a significant increase in responsibilities, the employer may not work to increase the person’s pay to the minimum until all facets of the new job are being fully performed. Generally, it is recommended that the green-circled individual receive pay increases to get to the pay grade minimum fairly rapidly. More frequent increases can be given if the increase to minimum would be large.

### Pay Compression

One major problem many employers face is **pay compression**, which occurs when the range of pay differences among individuals with different levels of experience and performance becomes small. Pay compression occurs for a number of reasons, but the major one involves the situation in which labor market pay levels increase more rapidly than an employee’s pay adjustments. Such situations
have become prevalent in many occupational areas, particularly those in the information technology field.28

Occasionally, in response to competitive market shortages of particular job skills, managers may have to deviate from the priced grades to hire people with scarce skills. For example, suppose the worth of a specialized information systems analyst’s job is evaluated at $38,000 to $48,000 annual salary in a company, but qualified individuals are in short supply and other employers are paying $60,000. The firm must pay the higher rate. But suppose several analysts who have been with the firm for several years started at $38,000 and have received 6% increases each year. These current employees may still be making less than salaries paid to attract and retain new analysts from outside with lesser experience. One solution to pay compression is to have employees follow a step progression based on length of service, assuming performance is satisfactory or better.

**Pay Increases**

Once pay ranges have been developed and individuals’ placements within the ranges identified, managers must look at adjustment to individual pay. Decisions about pay increases often are critical ones in the relationships among employees, their managers, and the organization. Individuals have expectations about their pay and about how much increase is “fair,” especially in comparison with the increases received by other employees. There are several ways to determine pay increases.

**PAY-FOR-PERFORMANCE SYSTEMS** Many employers profess to have a pay system based on performance. But relying on performance-appraisal information for making pay adjustments assumes that the appraisals are done well, and this is not always the case, especially for employees whose work cannot be measured easily. Consequently, some system for integrating appraisals and pay changes must be developed and applied equally. Often, this integration is done through the use of a pay adjustment matrix, or salary guide chart (see Figure 13—17). Pay adjustment matrices base adjustments in part on a person’s compa-ratio, which is the pay level divided by the midpoint of the pay range. To illustrate from Figure 13—17, the compa-ratio for two employees would be:

\[
\text{Employee } R = \frac{16.50 \text{ (current pay)}}{15.00 \text{ (midpoint)}} \times 100 \rightarrow \text{Compa-ratio } = 110
\]

\[
\text{Employee } J = \frac{13.05 \text{ (current pay)}}{15.00 \text{ (midpoint)}} \times 100 \rightarrow \text{Compa-ratio } = 87
\]

Such charts reflect a person’s upward movement in an organization. Upward movement depends on the person’s performance, as rated in an appraisal, and on the person’s position in the pay range, which has some relation to experience as well. A person’s placement on the chart determines what pay raise the person should receive. For example, if employee J is rated as exceeding expectations (3) with a compa-ratio of 89, that person is eligible for a raise of 7% to 9% according to the chart in Figure 13—17.

The sample matrix has several interesting facets that illustrate the emphasis on paying for performance. First, those individuals whose performance is below expectations receive no raises, not even a so-called cost-of-living raise. This ap-
proach sends a very strong signal that poor performers will not continue to re-
ceive increases just by completing another year of service.

Second, notice that as employees move up the pay range, they must exhibit
higher performance to obtain the same percentage raise as those lower in the
range performing at the “meets performance expectations” (2) level. This ap-
proach is taken because the firm is paying above the market midpoint but re-
ceiving only satisfactory performance rather than above-market performance.
Charts can be constructed to reflect the specific pay-for-performance policy and
philosophy in an organization.

In many organizations, pay-for-performance systems are becoming a popular
way to change the way pay increases are distributed. In a truly performance-
oriented system, no pay raises are given except for increases in performance. Giv-
ing pay increases to people because they have 10 to 15 years’ experience, even
though they are mediocre employees, defeats the approach. Further, unless the
performance-based portion of a pay increase is fairly significant, employees may
feel it is not worth the extra effort. Giving an outstanding industrial designer
making $40,000 a year the “standard raise” of 4% plus 1% for merit means only
$400 for merit versus $1,600 for “hanging around another year.”

<table>
<thead>
<tr>
<th>Pay Grade (hourly rates)</th>
<th>Maximum = $18.00</th>
<th>Employee R = $16.50</th>
<th>Midpoint = $15.00</th>
<th>Employee J = $13.05</th>
<th>Minimum = $12.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pay Grade (percent of midpoint)</td>
<td>A1 0%</td>
<td>A2 0%</td>
<td>A3 0–3%</td>
<td>B1 0%</td>
<td>B2 0%–3%</td>
</tr>
<tr>
<td>Performance Appraisal</td>
<td>Does Not Meet Performance Expectations 1</td>
<td>Meets Performance Expectations 2</td>
<td>Exceeds Performance Expectations 3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**FIGURE 13–17 Pay Adjustment Matrix**
**SENIORITY**  Seniority, or time spent in the organization or on a particular job, can be used as the basis for pay increases. Many employers have policies requiring that persons be employed for a certain length of time before they are eligible for pay increases. Pay adjustments based on seniority often are set as automatic steps once a person has been employed the required length of time, although performance must be at least satisfactory in many nonunion systems.

A closely related approach uses a **maturity curve**, which depicts the relationship between experience and pay rates. Pay rises as an employee's experience increases, which is especially useful for professionals and skilled craft employees. Unlike a true seniority system, in which a pay raise occurs automatically once someone has put in the required time, a system using maturity curves is built on the assumption that as experience increases, proficiency and performance also increase, so pay raises are appropriate. If proficiency does not increase, theoretically pay adjustments are reduced, although that seldom happens in practice. Once a person plateaus in proficiency, then the pay progression is limited to following the overall movement of the pay structure.

**COST-OF-LIVING ADJUSTMENTS (COLA)**  A common pay-raise practice is the use of a **standard raise or cost-of-living adjustment** (COLA). Giving all employees a standard percentage increase enables them to maintain the same real wages in a period of economic inflation. Often, these adjustments are tied to changes in the Consumer Price Index (CPI) or some other general economic measure. However, numerous studies have revealed that the CPI overstates the actual cost of living.

Unfortunately, some employers give across-the-board raises and call them **merit raises**, which they are not. If all employees get a pay increase, it is legitimately viewed as a cost-of-living adjustment having little to do with merit or good performance. For this reason, employers should reserve the term **merit** for any amount above the standard raise, and they should state clearly which amount is for performance and which is the “automatic” COLA adjustment.

**LUMP-SUM INCREASES (LSI)**  Most employees who receive pay increases, either for merit or seniority, first have their base pay adjusted and then receive an increase in the amount of their regular monthly or weekly paycheck. For example, an employee who makes $12.00 per hour and then receives a 3% increase will move to $12.36 per hour.

In contrast, a **lump-sum increase (LSI)** is a one-time payment of all or part of a yearly pay increase. The pure LSI approach does not increase the base pay. Therefore, in this example the person’s base pay remains at $12.00 per hour. If an LSI of 3% is granted, then the person received $748.80 (computed as 36¢ per hour × 2080 working hours in the year.) However, the base rate remains at $12.00 per hour. It is that base rate upon which overtime is figured, and keeping the base rate static slows down the progression of the base wages. It also allows for the amount of the “lump” to be varied, without having to continually raise the base rate. Some organizations place a limit on how much of a merit increase can be taken as a lump-sum payment. Other organizations split the lump sum into two checks, each representing one-half of the year’s pay raise.

As with any plan, there are advantages and disadvantages. The major advantage of an LSI plan is that it heightens employees’ awareness of what their performance “merited.” A lump-sum check also gives employees some flexibil-

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**Maturity curve**  Curve that depicts the relationship between experience and pay rates.

**BNA:**  **General Increases**  Different methods of determining general pay increases, including the cost-of-living approach and others, are discussed at 2225.10.
ity in their spending patterns so that they can buy big-ticket items without having to take out a loan. In addition, the firm can slow down the increase of base pay, so that the compounding effect of succeeding raises is reduced. Unionized employers, such as Boeing and Ford, have negotiated LSI plans as a way to hold down base wages, which also holds down the rates paid for overtime work. Pension costs and some other benefits, often tied to base wages, can be reduced as well.

One disadvantage of LSI plans is administrative tracking, including a system to handle income tax and Social Security deductions from the lump-sum check. Also, workers who take a lump-sum payment may become discouraged because their base pay has not changed. Unions generally resist LSI programs because of this and because of the impact on pensions and benefits. To some extent, this problem can be reduced if the pay increase is split to include some in the base pay and the rest in the lump-sum payment.

**Summary**

- Compensation provided by an organization can come both directly through base pay and variable pay, and indirectly through benefits.
- Compensation responsibilities of both HR specialists and managers must be performed well. Compensation practices are closely related to organizational culture, philosophies, strategies, and objectives.
- A continuum of compensation philosophies exists, ranging from an entitlement-oriented philosophy to a performance-oriented philosophy.
- Compensation strategies are shifting, and organizations must balance cost-effectiveness with labor market realities.
- Competency-based pay that focuses on what capabilities people have is growing in usage.
- Broadbanding, which uses fewer pay grades with wider ranges, provides greater career movement possibilities for employees.
- Variable-pay programs, including those that are team based, are being used to enhance organizational performance and reward greater employee participation in work teams.
- When designing and administering compensation programs, behavioral aspects must be considered. Equity, organizational justice, pay openness, and external equity are all important.
- The Fair Labor Standards Act (FLSA), as amended, is the major federal law that affects pay systems. It requires most organizations to pay a minimum wage and to comply with overtime provisions, including appropriately classifying employees as exempt or nonexempt and as independent contractors or employees.
- Other laws place restrictions on employers who have federal supply contracts or federal construction contracts, or on those employers who garnish employees’ pay.
- Administration of a wage and salary system requires the development of pay policies that incorporate internal and external equity considerations.
- Job evaluation determines the relative worth of jobs. Several different evaluation methods exist, with the point method being the most widely used.
- Once the job evaluation process has been completed, pay survey data must be collected and a pay structure developed. An effective pay system requires that changes continue to be made as needed.
- Developing a pay structure includes grouping jobs into pay grades and establishing a pay range for each grade. Broadbanding, which uses fewer pay grades with broader ranges, is growing in popularity.
- Individual pay must take into account employees’ placement within pay grades. Problems involving rates above or below range and pay compression must be addressed.
- Individual pay increases can be based on performance, cost-of-living adjustments, seniority, or a combination of approaches.