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EFFECTIVE MARKET-BASED PAY SYSTEMS

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Overview

As the number of available compensation surveys grows and labor markets become increasingly dynamic, more and more companies are establishing market-based pay systems to replace other types of job evaluation systems. This is driven largely by an organization's ongoing need to offer competitive rates of pay to attract and retain employees. Most employers have at some point dealt with pay programs that are not sufficiently linked to their relevant external labor market(s) and realize the criticality of a pay system that monitors and responds to market pay changes proactively. But the effectiveness of any job evaluation system, measured by its fairness and consistency in evaluating jobs and distinguishing pay levels, is the true test of its value. This Trends+Issues provides a logical process for establishing and maintaining an efficient market-based pay system.

Change is a universal attribute of today's workplace. For a multitude of reasons, nothing stays the same for long. Organizations rethink strategy and rebuild, departments reorganize, jobs are restructured and employees retrained. And because technology has enabled almost all organizations to move at a faster pace, change is more often thrust upon us than it is phased in over time. As such, adaptability has become synonymous with viability in today's business environment. More often than not, market-leading organizations foresee external trends and shifts impacting their industry and customer base and respond to them efficiently and effectively. High performers develop the skills and knowledge they need to thrive despite a reshuffling of priorities and focus. And effective pay strategies and reward systems anticipate and respond to a changing organization efficiently.

Frequently today's executives voice an opinion that goes something like this: "Our employees are the most important asset and paramount to our success". "We must empower them, treat them fairly and reward them well for their positive contributions and results." At the risk of diminishing this enlightened (and often sincere) sentiment, talk is cheap and can fuel employee cynicism if not supported by tangible programs and actions. How does your pay system score in terms of fairness, validity and consistency?

Key Questions to Evaluate Your Organization's Pay System:

1. Does your pay system respond to changes in the external labor market?
2. Are rates of pay defendable to manager and employee alike?
3. Does the system differentiate reward levels based on skills, responsibility, contribution, performance and other important variables?
4. Is the pay system linked to the corporate strategy?
5. Is the pay system cost effective? Is it easy to explain and understand?
6. Do employees understand the process used to determine their pay levels and consider it to be fair?
7. Is your organization able to hire and retain quality staff?

An effective pay system scores a "yes" on every question. Well-designed market pay systems are proving to be the most responsive to changes in the external marketplace and the simplest to administer and communicate.

An External View

External market pay rates are an important gauge of the competitiveness of internal pay targets and actual pay rates. And studies suggest that this external comparison is gaining strength as the primary determinant of pay for most organizations. The shift toward market-based job evaluation systems and away from internal equity systems (such as factor comparison and point factor, which place primary importance on internal relationships in valuing jobs) has occurred for two fundamental reasons: 1) Market pay systems are easy to understand and flexible enough to respond to changes that directly impact an organization and its industry, and 2) today's typical employer/employee affiliation tends to be shorter and grounded in the here and now as opposed to the career length affiliations of past generations that elevated the importance of internal equity over external competitiveness.

Monitoring the market provides important information, such as an understanding of when a scarcity of talent drives up pay levels and when this scarcity subsides or even results in a glut of candidates for certain jobs that might lower pay levels. Employers can also monitor industry changes by observing benchmark job changes over time. All of this information strengthens the link between an organization and its relevant labor markets and averts the risky endeavor of ignoring competitors and making decisions in a vacuum.

Much has been written about the "free agent" mentality of today's workers — particularly younger ones — and the absence of strong company loyalty and commitment. While enough long tenured employees exist to avoid over-generalizing the situation, it is hard to deny that times have changed. Job loss across all levels of corporate America during the 1980s and 1990s due to restructuring, mergers and acquisitions, and technological advancements directly impacted many employees in today's workforce or the parents, relatives, neighbors and friends of today's workers. The lessons learned from that time period were that loyalty to an organization did not always save employees from losing their jobs nor did it provide them with the up-to-date skills needed to survive (and thrive) in our technology-driven world. From this reality has emerged a worker who wants to control his own career and continue to acquire marketable skills and an employer who recognizes the importance of a skilled staff that continues to learn and adapt. By virtue of what they value and consider important, both parties tend to be more focused on external competitiveness than they are internal equity.

In discussing the popularity of market-based pay systems in today's work environment, we would be remiss not to mention the Internet and its profound impact on pay and pay communication. Employees have easy access to (not always reliable) compensation data on the Web, which often leads to questions regarding their own pay rates. Not surprisingly, these employees tend not to be placated by the knowledge that their pay is equitable inside the organization. A more appropriate response is valid survey data that supports the organization's pay position against the external marketplace and an explanation of the criteria that must be met before pay data is considered a reliable gauge of the relevant market. In fact, some organizations require from their employees an outline of the methodology used to collect specific Internet pay data that meets the organization's standards before making the argument that they are underpaid against such findings.

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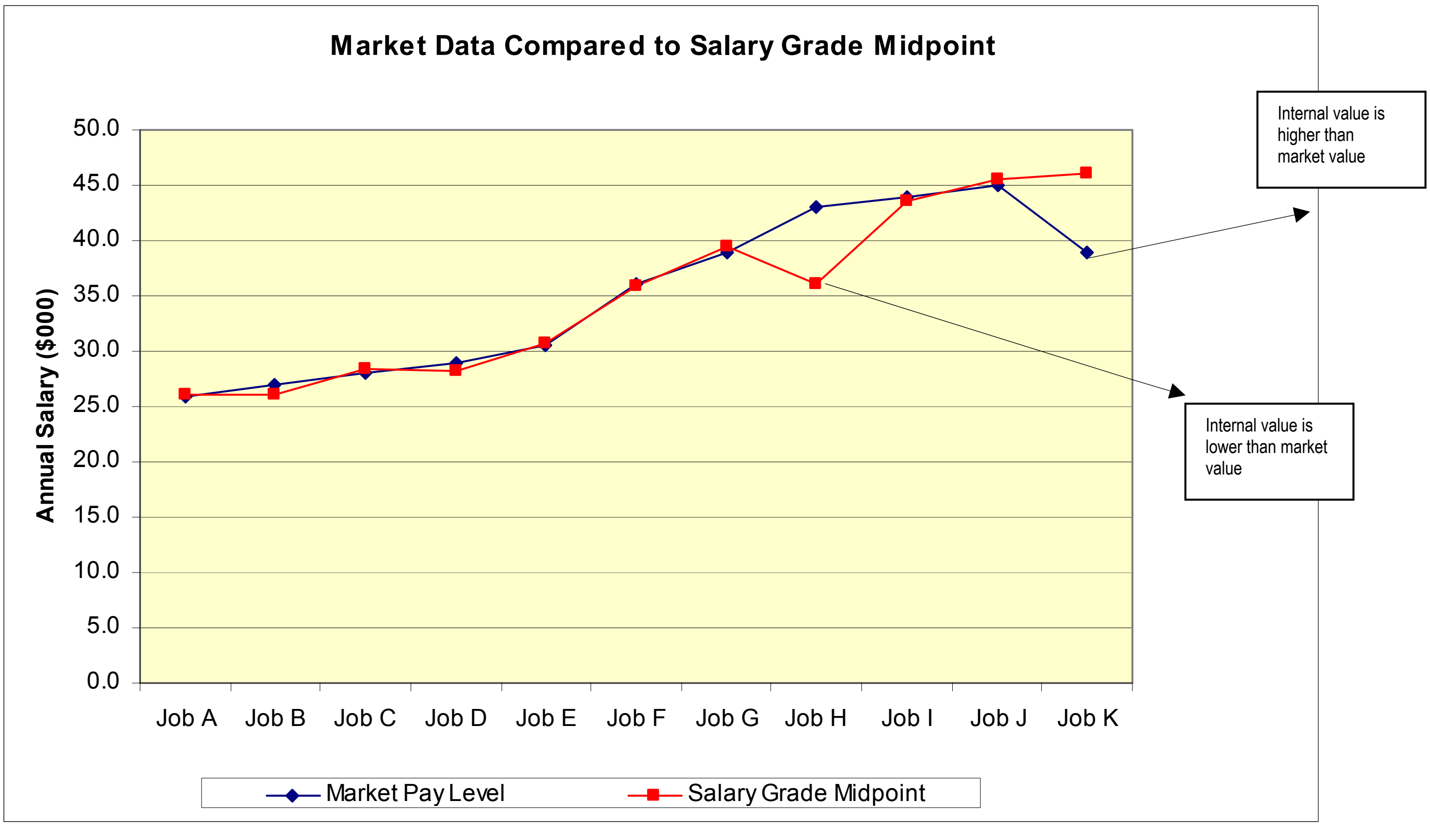
Internal Equity — Don't Ignore It

By definition, market pay systems place primary emphasis on external competitiveness. This does not mean that internal equity is not important — it is, and it must be monitored. When external competitiveness and internal equity conflict (and they will conflict), defaulting automatically to market without considering potential internal issues is a mistake, even from the market purist perspective.



When a job's external value is higher or lower than its internal value, organizations must determine whether the difference can be tracked to the job or to the incumbent holding the job. If the difference is in the actual job, a premium or discount (typically 5% to 20%) can be applied to the market data to reflect the variance between typical duties defining the benchmark and actual duties defining the real job. If the difference can be attributed to the incumbent performing the job, this is typically an issue related either to the incumbent's actual pay rate against target or to the appropriateness of the job documentation.

Keep in mind that internal equity has many strands and some are inherently more important than others. Balancing equity across disciplines, for example, is usually less important than balancing it within the same discipline, or job family. For this reason, it is recommended that market pay data be organized and analyzed by job family to ensure an internal equity review of jobs within the same discipline. When market pay rates differ for two jobs in the same family that are internally equal, additional analysis is required to justify either paying the jobs according to market or deviating from market and paying the jobs the same.

Job Family Example: Accounting					
←←Experience, knowledge, Skills, Responsibilities →→					
Accounting Representative	Accountant, Entry Level	Accountant, Intermediate	Accountant, Senior	Accounting Supervisor	Accounting Manager

Good Data and Good Judgment: It Takes Both

Market pricing (or matching internal jobs to comparable external ones and collecting relevant compensation data) is part art, part science. While the depth and breadth of compensation data compiled in published surveys has never been stronger, data alone will not provide all of the answers. Good judgment is essential to market pricing and related compensation recommendations. Here is some practical information on market pricing broken down by work step.

1. Market Pricing Methodology

The market pricing methodology is the blueprint used to complete the market pay study. It includes detail on each step of the pay study from benchmark selection to data interpretation and communication. The amount of time spent planning and developing a thorough market pricing methodology is always worth it, as it significantly reduces the rework time that often results from a less structured approach. This methodology is also used to communicate to managers the logic behind the market pay study.

2. Benchmark Job Selection and Relevant Labor Markets

Benchmark jobs are those that are not unique to an organization and can be readily matched to comparable jobs in the external marketplace. Benchmark jobs should represent all employee levels, cross all job families and include core and high population jobs. (When market pricing is the primary source of job evaluation, this benchmark group typically includes at least 50% of an organization's jobs.)

The relevant labor market is defined as the market from where an organization recruits employees and to where these employees go when they leave the organization. Accordingly, the labor market will vary by employee level, job family and sometimes job. And the labor market definition can fluctuate over time, so it should be monitored continually. A small non-profit organization, for example, will have some jobs that are industry-specific and others that are found in the general industry. While it might be good information to know what Fortune 500 companies are paying specific jobs, rarely would this group of employers represent *the* relevant labor market. At best, it would be one data source combined with others to arrive at an average market value. If, on the other hand, a $10 billion company in the local market is luring away the non-profit's administrative employees by paying significantly higher wages, this will require the organization to drill down its labor market definition and either adjust its pay rates to address the local competition or offer a counterbalance to the higher wages, such as a shorter workweek, flextime or other enticements.

Level	Typical Geographic Labor Market		
	Local	Regional	National
Executive			
Manager/Director			
Professional			
Support			

3. Survey Selection

Surveys vary in quality and scope, and the sources used to market price benchmark jobs will influence results. It is important to determine the most appropriate surveys for an organization based on the survey participants, the jobs and the relevant labor markets where people that hold these jobs live.

Ideally an organization will use numerous surveys to market price jobs because data will vary from one source to the next; collective results encompassing several sources are typically more reliable indicators of the going market rate. It is common, however, for one survey to take precedence over other surveys due to it representing a peer group of companies, the local labor market or some other important cross-section of employers. Maybe an organization eventually links its pay levels to this one source, but it is still important to collect data from other surveys in order to compare and contrast findings and make such decisions.

4. Data Collection

This step involves matching internal jobs to external benchmarks, selecting appropriate data that represents the relevant labor market and making judgment calls along the way.

Job Matching

Appropriate job matching is critical, and a pre-requisite to doing it well is to understand your internal jobs. (Knowledge of survey jobs is acquired over time and facilitates the market pricing process.) By virtue of its definition, a benchmark is generic enough so that it can be matched across a number of organizations. Accordingly, matching an internal job to a survey job is getting at the essence of the job and not matching duties bullet point for bullet point. (The bullet points are important, though, to understand the job.) Also, an internal job might be a hybrid of two or more market jobs, in which case it will be necessary to blend survey data to arrive at a collective picture of the job.

Projecting Survey Data

All survey data should be projected to one common date using the average annual salary adjustment for your industry. This helps alleviate the issue of survey data lagging behind the marketplace and allows for an “apples to apples” comparison of data. The date to which survey data is projected should be linked to your compensation plan year and your organization’s market positioning. If your organization lags the market, data will be projected to the first day of the plan year. If it leads the market for the first half of the year and lags market for the second half, data will be projected to the middle of the plan year. If it leads the market all year, data will be projected to the end of the plan year. Each position against market has cost implications, with the lag position being the most conservative and the lead position being the most aggressive.

Data Scope

While the data scope selected should reflect the relevant labor market, keep in mind that survey data subsets can get thin and be less reliable than a full sample. For this reason, a number of organizations use all reporting, national pay data as the market indicator and apply the appropriate geographic differential to reflect the local or regional labor market or a factor to reflect the organization’s revenue size as compared to national data. (Revenue-specific trend data is usually arrived at by comparing revenue data cuts to the full sample by survey source for a number of jobs.)

Data Points

Your organization maintains a pay position against the relevant external market that is below, at or above the going rate of pay. Regardless of this pay position, pull available survey data for base pay and total cash compensation (base pay plus annual incentive) at the low-end, middle and high-end of the market. The low and high market rates reported in most surveys are the 25th and 75th percentiles, or the point below which 25% and 75% of the data fall, respectively. The middle point, or the median, is considered the competitive market pay rate. All three data points are important, as they provide the market range for the job and should be referenced in setting pay ranges and determining incentive opportunity.

Programmer Analyst: National Scope; Survey Data Effective September 2004								
Survey Code	**Position**	**Matches**	**Base Pay ($000)**			**Total Cash ($000)**		
			25th	**50th**	**75th**	**25th**	**50th**	**75th**
1	Programmer Analyst II (1-3 yrs exp)	57	48.0	52.2	54.4	49.0	53.4	55.6
2	Intermediate Programmer/Analyst (2-4 yrs exp)	77	48.6	50.5	56.3	50.7	51.9	56.3
3	Midrange Programmer, Level 2 (1-3 yrs exp)	12	45.0	51.2	57.8	47.0	52.2	58.4
	Average	**49**	**47.2**	**51.3**	**56.2**	**48.9**	**52.5**	**56.8**
	Incumbent Weighted Average		**48.1**	**51.2**	**55.6**	**49.7**	**52.5**	**56.2**

5. Data Interpretation

While data is analyzed throughout the data collection process, this step looks at the aggregate results as compared to the individual survey data. Areas to troubleshoot include:

Wide fluctuation in a job's pay level from one survey to the next: Ideally there will be no more than a 15% difference from the lowest survey data point to the highest, but sometimes the fluctuation will be much higher. If one survey reports a pay rate that is either extremely high or extremely low compared to the other data points, it might make sense to remove this survey's data from the analysis. But don't do so before reviewing the situation and potential reasons for the difference, such as the strength of the match or the survey participant list. (The higher or lower data point might actually be reported by the survey your organization considers the most important.)

Dramatic change in a job's value reported in a survey from one year to the next. When this change is an increase, it is typically attributed to a tight labor market and not reviewed extensively. When it is a decrease, it tends to be a bigger issue and the validity of the data could be questioned. A key aspect of the market is that it fluctuates; pay rates usually increase over time, but they can decrease. If a survey reports a change in pay from one year to the next that is more than 10%, review the data carefully and attempt to understand the reason for the change.

When a job's market pay level decreases over time, it is less common for an organization to cut the job incumbents' actual pay rates than it is for it to cut the targeted pay rate. In situations where targets are lowered, incumbents paid too high against target (usually based on their performance and skill levels) will typically have their base pay frozen until they reach the appropriate pay position relative to the market pay rate.

Total cash compensation is lower than base pay. Because total cash compensation equals base pay plus annual incentive, it should never be lower than base pay. There is a possibility, however, that survey participants will provide data on base pay but not total cash compensation for a job, causing the survey's aggregate findings to include more data points for base pay than for total cash. In this situation, the reported base pay level could be higher than total cash compensation. Realistically, this will not be the case.

6. **Manager Communication**

Effective communication of market pay study results goes a long way toward their validity and acceptance.

Before collecting pay data, it is a good idea to provide managers with a copy of the pay study methodology and a short composite survey description for each job's market match. This approach will help ensure that job matching and labor market issues are addressed and resolved before the intensive data collection process begins.

Following completion of the market pay study, provide managers with a summary of findings and the detailed survey data. A common issue is survey data coming in lower than what managers are up against in the current labor market. Communicate to managers that the survey data sample does not reflect new hire rates only that are often inflated due to high demand and low supply situations; rather, the data represents all incumbents. Provided data sources are reputable and the data is specific enough, the results are often a good indicator of the market rate, and the additional amount that must be paid to hire and retain employees is due to market pressures. While these market pressures should be addressed in the short term by increasing the pay target on a temporary basis or providing variable pay opportunity, the validity of the survey data should not be discredited or considered lacking if it does not completely jive with current hiring conditions.

Establishing Market-Based Pay Systems

Market based pay systems continue to replace internally focused pay systems due largely to the prevalence of published survey data and the realties of competing for talent in an external market that rewards movement from one employer to another. Establishing a pay system that adjusts to changes in the labor market will help employers maintain a competitive system that is fair and defensible to managers and employees alike.

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