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MONEY TALKS

Identifying, Preventing and Alleviating Systemic Salary Compression Issues

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QUICK LOOK

- Employees in a compression situation may feel that their tenure and experience are not valued and that historical knowledge and contribution are not respected.
- It is easier to avert salary-compression situations than to fix them.
- Recommendations for merit pay increases should be based on formal assessments of performance.

Employers design compensation programs intended to motivate employees to reach their highest level of capability, allow the best performers to move up in the organization and ultimately link pay to performance and results. The overall objective is to deliver higher pay to employees who have greater responsibility, perform better than others and have a greater positive impact on the organization. In the process of meeting this objective, however, organizations can create situations where this doesn't occur.

Typically, isolated pay-compression situations do occur in organizations and, as long as there is credible rationale to account for the resulting pay difference, it is generally not an issue. However, when inequities occur *systemically*, either throughout the organization or across a group of positions, and they are allowed to continue over an extended period, serious employee

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morale issues can arise. Addressing these inequities may require a more focused approach.

This article looks at three situations involving systemic salary compression, defined by WorldatWork as "pay differentials too small to be considered equitable." It examines some causes of those occurrences and how employers can minimize their negative impact.

Although addressing employee morale issues in a weak economy when many employees are happy just to have a paycheck may seem ironic — or unnecessary — the fact is that productive, highly skilled workers who feel adversely affected by salary compression can very likely find employment elsewhere. In the "war for talent," salary compression directly conflicts with the typical organization's pay philosophy and its strategic long-term HR goals.

Case One: Newly hired employees paid more than existing employees

In a tight labor market, an employer may find itself having to offer similar or even higher initial starting salaries to new hires than to more experienced employees. This can occur with new college graduates versus employees with a few years of experience. Another example is a new hire with only a few years of experience but with long-term career potential commanding a starting salary greater than his/her more experienced co-workers performing similar work.

The question arises: Have current employees' pay levels not kept pace with what the employer finds is necessary to offer to new hires? As a practical matter, since overall merit increase budgets have been hovering around 3.5 percent to 4.0 percent during the past few years, merit increases may not have kept pace with market conditions, particularly for positions that are highly in demand. This situation, combined with the fact that high-performing current employees may have received an increase of only 1 percent to 2 percent higher (if that) than those employees with adequate or below adequate performance, means that an organization's best performers might be less than competitive. Should these employees be demotivated by this circumstance, their morale is likely to sink even lower in the presence of untested new hires who are working side by side with them or who they may, in fact, be training.

Case Two: Changing organizational needs require employees with different skills

As the business environment changes and organizations have to assess their workforce to remain competitive or even compliant, they may determine that some existing positions now require higher-level — or different — skills than what their current employees possess. For example, new government regulations that have considerable impact on an organization may require bringing on board new employees with specific compliance knowledge or expertise. Or, an organization may determine that its HR staff needs to better partner with its business-unit heads and might thus require its employees to possess more financial expertise.

Whether the nature of the position has changed because of external factors or solely because of management expectations, it is possible that different technical and/or professional requirements are needed, which new hires possess and current employees do not, all of which impacts pay relationships within an organization.

Case Three: Subordinates paid the same as or more than their supervisors

This generally occurs with first-line supervisors overseeing the highest-level nonexempt (hourly) employees who also are typically working side by side with each other; the nonexempt employees are paid overtime, and their supervisors are not paid for additional hours worked. This can occur in a union environment as well, with the union employee on a negotiated salary scale and the nonunion

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supervisor paid according to company guidelines. If the supervisor/manager does not actually possess the same level of technical skill as the nonexempt subordinate, the differential may be acceptable. Or, if the supervisor is on an upward career path, this may be a temporary disparity. However, if the supervisor is in a career-end position, over time, he/she may determine that it is just not worth taking on the added responsibility and pressure involved in supervision with a "decrease" in pay.

The Impact of Salary Compression on Existing Employees

Employees often do not understand their company's pay philosophy, possibly because they have never heard management articulate it. They also may not be aware of the details of their organization's compensation program. Unfortunately, employee ignorance rarely equals bliss. On the contrary, this type of environment can be very demotivating to many employees, especially if they perceive that different people are paid according to different rules.

Employees in a compression situation may feel that their tenure and experience are not valued and that historical knowledge and contribution are not respected. This can lead to a lack of cooperation with new employees and, quite possibly, an inclination to take the next call from a recruiter.

While employees want to understand what it takes to earn more pay, if they are not clear on what it takes to earn more and thus move ahead, they may conclude that changing companies is the surest way to increase their salary and career prospects.

Preventive Actions

It is easier to avert salary-compression situations than to fix them. Maintaining a robust compensation program with open lines of communication and built-in checkpoints among the various HR functions is key to preventing and, when necessary, resolving these situations.

Company recruiters are the first line of defense. They are connected to the candidate pool and have their fingers on the pulse of the market. They can identify the positions for which candidates are in short supply and assess the difficulty of getting acceptance of specific job offers. Establishing formal hiring rates and evaluating them on an ongoing basis will ensure that offers extended are within the range of current employees' pay for those jobs.

It is also important that job salary ranges are regularly benchmarked to the market to ensure that the organization maintains its desired pay position versus its competition.

Finally, recommendations for merit pay increases should be based on formal assessments of performance. This is more likely to ensure that those performing at a higher level receive a higher-percentage increase. Once completed, an equity review correlating the percent of pay increase against performance levels will bring to light any issues or inequities.

Solutions

Preventive action will ensure that compression situations (if any arise) are addressed early on, before the issue becomes unmanageable. The key is to maintain a sound salary administration program with a strong and current link to market. However, if your organization is already in the throes of compression, the following solutions can help alleviate it:

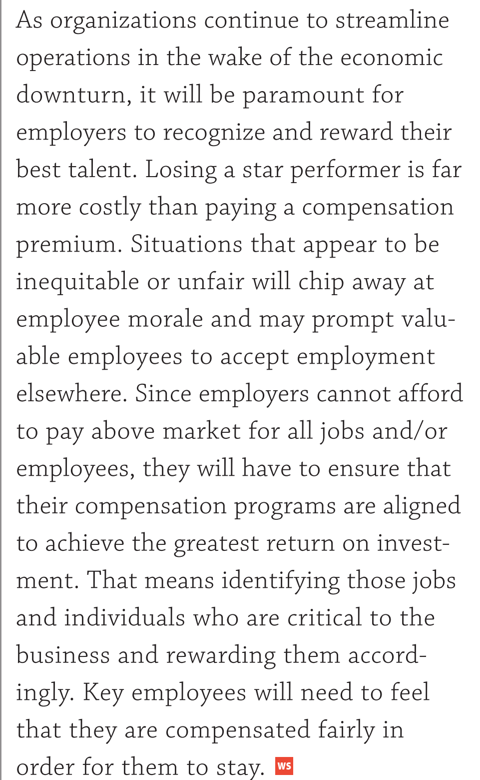
- If the budget permits, consider building in extra funding to the annual increase budget, either to be used as a one-time adjustment or spread over a period of time.
- If no additional funding is available, hold back a small portion of the merit or promotional budget to "fix" problems. As an example, if the overall budget is 3.75 percent, use 3.25 percent for merit and 0.5 percent to resolve compression issues.
- Stretch out the review period beyond 12 months for those at the high end of the range and for employees who do not meet expectations. For those at the high end of the range, this will have the effect of slowing down

increases and will help ease compression. Stretching out the increase beyond 12 months for poorer performers means these employees will have to wait longer for their increase, saving the company money, which can then be delivered to better performers. Psychologically, the employee perceives that he/she is receiving the standard merit percentage, but the net result will be less money.

- For those on the high end of the pay range, consider providing the merit increase as a lump-sum payment rather than building it into the base salary; thus the actual base salary stays the same, and while the increase is not built into benefits, the effect of a large payment to an employee can be positive.
- Consider offering a hiring bonus in lieu of a higher starting salary in a unique situation. Be sure to have the employee sign an agreement to repay the bonus if he/she leaves before a specified period of time.
- If the organization's workforce requirements permit, consider hiring less experienced employees who can be trained. This option offers a great opportunity to employees who have high potential and highlights the organization's commitment to career development for all employees.
- Conduct a work assessment. Review work to be accomplished and employee capabilities with a view to reorganizing and reducing staff levels as part of attrition or for performance. With fewer but more productive employees, pay can be delivered to those who are most critical to the organization.

Relative to the specific situations discussed in this article, the following are some solutions to consider:

- **Newly hired employees paid more than existing employees:** Employers and employees need to acknowledge and accept the fact that the market clearly recognizes that it must reward the steeper learning curves that typify an employee's early career. This means employers should build more frequent pay increases into the "building career" levels to reflect the presumed growth in capability that comes with climbing a steep learning curve. Developing a formal career path, especially for individual-contributor roles, is highly effective, particularly when there is a pay component associated with achieving that higher stage or level of responsibility and achievement.
- **Changing organizational needs require employees with different skills:** Should an organization require different or enhanced skills that the current staff does not possess, the challenge is somewhat more complex, particularly if the current staff is not capable of adapting to the changed environment. The priority is to communicate management's new expectations and what employees must do in order to increase earning potential or even to maintain their job. Otherwise, pay will be static. This situation requires that employers provide clear performance expectations, as well as potential training and counseling.
- **Subordinates paid the same as or more than their supervisors:** In the subordinate/supervisor pay overlap, employers may want to evaluate the conditions to determine whether it is a one-time situation or an ongoing one. Unique situations can often be resolved with a "spot bonus" or a one-time special payment. With ongoing situations, employers may want to consider paying management overtime or year-end bonuses, particularly if the supervisor is in a career-end position.



Conclusion

As organizations continue to streamline operations in the wake of the economic downturn, it will be paramount for employers to recognize and reward their best talent. Losing a star performer is far more costly than paying a compensation premium. Situations that appear to be inequitable or unfair will chip away at employee morale and may prompt valuable employees to accept employment elsewhere. Since employers cannot afford to pay above market for all jobs and/or employees, they will have to ensure that their compensation programs are aligned to achieve the greatest return on investment. That means identifying those jobs and individuals who are critical to the business and rewarding them accordingly. Key employees will need to feel that they are compensated fairly in order for them to stay. WS

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