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Effectively Managing Base Pay: Strategies & Programs For Success

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Base pay is the largest component of the total compensation package for most employees (exceptions being direct sales personnel and top executives in organizations that utilize variable pay and equity plans heavily). Wages/salaries represent the largest cost item for many organizations and failing to manage them effectively is a sure ticket to poor organizational performance.

Base pay is the foundation for total compensation, since it establishes the standard of living for employees. It also serves as the primary indication of the value the organization places on the role an employee plays and on the contributions the employee makes. For this reason the subject elicits great emotion and is often the source of conflict between the employee and the organization. It is therefore critical that base pay rates are viewed by both the organization and by employees as being:

- internally equitable
- externally competitive
- affordable/cost effective
- legal/defensible
- understandable
- appropriate for the organization
- appropriate for the workforce.

There are three primary approaches to determining pay. The first, *merit pay,* is based on the role an employee plays in the organization and how well they perform that role (a.k.a., a "pay the job" approach). The second, *person-based pay,* is based on what the employee brings to the organization, in the form of knowledge, skills, abilities and behaviors (a.k.a., a "pay the person" approach). The last, *results-based pay,* typically is not delivered in the form of base pay, but rather utilizes variable pay programs to reward results. This paper will focus on the first two approaches.

The literature in the compensation field seems to be on a continual search for the holy grail, the one quick fix that will address the challenges of paying people in a manner that elicits their best and that attracts and retains the best people. This quest is of course futile and the answer to "what is best" is "what fits." What fits the organization (or portion of the organization), what fits the employees (or category of employees) and what is both effective and affordable may be "all of the above." Therefore the compensation practitioner must understand all the approaches, assess the context and fit the program to that context.

Merit Pay

For decades the principal approach to administering base pay has been merit pay, at least in the U.S. This approach bases an employee's pay rate on the value of the job/role held, the degree to which the employee has mastered that job/role and how well the employee has performed over time. The value of the job/role is determined by both its relative internal value and its external (market) value. The value determines the range of base pay opportunity for incumbents. Where an employee's pay rate falls within that pay range depends on their mastery and their performance.

Merit pay has proclaimed dead and/or impossible to administer well repeatedly during its reign. But 90+% of the Malcolm Baldridge Award winners still use it as their primary tool for eliciting and rewarding performance, so it is hard to take this pessimistic view seriously. On the other hand, merit pay is devilishly difficult to get right and organizations continue to evolve their programs attempting to increase its effectiveness. Research has shown again and again that pay for performance *can* positively impact performance, but it must be seen as being *tied to* performance.

Expectancy theory predicts that people will perform better if they believe they are *able to* achieve what is desired, are *allowed to* do what it will take, if they *want to* achieve it, and, of course, that they *know what "it" is.* Appropriate staffing, development, performance management and rewards strategies can address all these prerequisites. One of the failures most often encountered in firms that believe their merit pay programs are not successful is the lack of a strong, consistent connection between performance and rewards. That is where a sound merit pay program can help. By clearly communicating performance criteria and standards in advance, providing continuous feedback on results and making rewards clearly contingent on performance the organization provides the stimulus for high levels of effort and the focus for applying that effort to the organization's objectives.

Many merit pay programs are underpowered. By failing to provide an adequate budget for performance-based adjustments the potential impact of the program is diluted. If an organization with a 4% salary increase budget adjusts its salary structure by 3% and then passes that on to every employee, it is left with only 1% to differentiate between the highest and lowest levels of performance. On top of this, many fall into the trap of "giving increases for performance" rather than "paying for performance." There is a difference.

If someone is paid at or near the top of their range they are well (15-20%) above the market rate… and if their performance is at a "meets expectations" level they are already adequately paid. Therefore an increase is not justified. Then why do 99+% of employees typically get an increase every year? Because no one has clearly articulated that if an employee is already at or above the pay level warranted by performance that no entitlement to an increase exists. Since employees feel the organization has always given them an increase, often with little explanation, it seems reasonable they expect this will continue.

Exhibit 1 illustrates the concept of paying for performance. The underlying philosophy is that increases will be based both on performance and on the position of the current pay rate in the established pay range. The largest increases go to employees low in the range who perform at high levels; the smallest (or no) increases to those high in the range who perform at low levels. If this philosophy is not applied and employees are given increases without considering the current pay rate those who are paid more will pull away from those who are paid less… even though convergence of pay rates over time is the desired result. Even worse, those very employees who are most prone to leave the organization (low paid; high performing) are the ones the organization most wants to keep (low cost; high contribution)… and yet is rewarding the least.

Exhibit 1 "Pay For Performance" Pay Increase Guidelines

		Position of Pay Rate In Range		
Performance Rating	**% Rated**	**Lower Third**	**Middle Third**	**Upper Third**
Outstanding	**10%**	**X + 5**	**X + 3**	**X + 1**
Significantly Exceeds Stds	**20%**	**X + 4**	**X + 2**	**X**
Fully Meets Standards	**65%**	**X + 3**	**X + 1**	**X – 1**
Does Not Fully Meet Standards	**5%**	**0 to X**	**0**	**0**
Unacceptable	**0-1%**	**Prob.**	**Prob.**	**Prob.**

- **X = amount salary structure is adjusted in current year**

The "X" in each of the cells is the amount the pay structure is adjusted in that year. Historical data for the last twenty-five years shows that average pay increase budgets are 1 ¼ to 1 ½% larger than average structure adjustments. This seems to be the minimum amount needed to move people through the range in reasonable timeframes. The + amounts will result in spending approximately 1 ½% on top of the structure adjustment (X), assuming performance ratings distribute as shown in the second column (% rated). If an organization rates a large percentage of employees in the "Outstanding" and "Significantly Exceeds" categories these guidelines will require a larger budget (the converse is true as well). Failure to distribute performance ratings reasonably will also weaken the pay - performance linkage over time. People will compare to others rated similarly and if the majority falls in the upper rating levels the distinction of being rated at a high level diminishes.

In order to administer guidelines like those in Exhibit 1 there must be an understanding of who should be paid in each of the sectors of the pay range, so that out of line pay rates can be corrected over time through pay actions.

Exhibit 2 illustrates guidelines for positioning employees where they belong in the range, based on performance and job mastery. This philosophy may run counter to the culture of some organizations. If seniority has always driven pay levels and pay actions this approach will be resisted. What is often overlooked is that this approach can be administered in a people-sensitive manner. If a long service employee hits a bumpy road and performance drops off the correction of range position is gradual and the option of getting performance back up to past levels is clearly open. This approach does limit the salary growth of those do not perform at high levels, but this is consistent with a business-oriented philosophy. Part of the reason managers never seem to have enough money to reward the high performers is that they use up too much of the budget giving increases to those already paid at or above the level warranted by their contributions.

Exhibit 2 Guidelines For Positioning Salary Rates In Range

Position In Range	**Profile Of Employees Who Belong In Sector**
Lower Third	**Has not reached full competence in all aspects of job; or, performance does not fully meet standards on a consistent basis.**
Middle Third	**Fully competent in all aspects of job and performance fully meets standards on a consistent basis.**
Upper Third	**Has mastered all aspects of job and provides guidance to others; performance has significantly exceeded standards over sustained periods.**

The objections put forth when a system like this are implemented are to be expected. When a top performer begins to get smaller increases than she is used to (expressed as a % of current pay) there are going to be questions. But the reasons are relatively easy to communicate. The first is that the organization finally woke up and realized it should consider how someone is currently paid before deciding what increase is appropriate. The second is that as the denominator gets bigger (the higher the pay rate) the smaller the percentage will be, given the same increase amount. The third is one of equity – a larger portion of the budget must be used to increase the pay of those low in the range (assuming performance warrants it). Even though some employees will still feel disadvantaged by the change in the rules management can at least convey the message that the approach is both sound from a business standpoint and equitable.

One of the problems experienced by many organizations with relatively stable, long service workforces is that their fixed costs for salaries become very high. And since variable pay programs and benefits are often tied to salary level their cost is escalated as well. In today's volatile environment a high fixed cost pay package is an impediment to sustained performance, particularly when revenues dive and the investment community drives down the stock price as a result of lower profits. High fixed people costs have contributed to the magnitude of job losses in many organizations. People who would be valuable to have around when things turn up are often let go when revenues decline – a byproduct of having direct compensation entirely in wages and salaries, which are fixed costs. This is one of the factors fueling the increased use of variable pay in the U.S. On the other hand, people got their mortgages on the basis of their salary (and not the uncertain incentive award) and executives and direct sales people are the only ones used to dealing with a partly contingent direct compensation package.

In response to the high fixed cost result of escalating salaries over time some organizations are beginning to utilize a modified approach to merit pay. This approach calls for the use of both base pay increases and performance-based cash awards. By reserving a portion of what would have been the base pay increase budget for cash awards the compounding effect on base payroll is diminished, since the cash awards do not increase base pay (and therefore fixed costs). Exhibit 3 illustrates this approach.

Exhibit 3 Combination Salary Increase/Cash Award Guidelines

Performance Rating	% Rated	Lower Third	Middle Third	Upper Third
Outstanding	10%	X +4 % 5 %	X + 2 % 5 %	X % 5 %
Significantly Exceeds Stds	20%	X + 3 % 2.5 %	X + 1 % 2.5 %	X – 1 % 2.5 %
Fully Meets Standards	65%	X + 2 % 0	X 0	X – 2 % 0
Does Not Fully Meet Standards	5%	0 to X 0	0 0	0 0
Unacceptable	0-1%	Pro- bation	Pro- Bation	Pro- bation

The amount in the top row of each cell relates to salary adjustments and is similar to Exhibit 2, except that each amount is 1% less. The 1% is reserved for cash awards, which are indicated on the second line in each cell. Since only 10% of employees are expected to be rated "Outstanding" the 5% cash awards for them will cost 0.5% of payroll. Approximately 20% of employees are expected to be rated "Significantly Exceeds Standards" so the 2.5% cash awards for them will cost 0.5% of payroll. Hence the 1% carved out of base pay adjustments are converted into cash awards and the base payroll going forward will be 1% less. The expenditure for adjustments and cash awards in that year will have been the same as it would have been if all of the money had gone into increases , but a portion of it will have to be re-earned in future years. In difficult times the amount diverted from base pay increases to cash awards could be increased, perhaps to 1.5 – 2%. At some point there is a danger that employees performing at adequate levels will rebel at the extreme distinctions being made based on performance and the negative impact on their base pay levels compared to prevailing market rates.

The use of cash awards in conjunction with base pay increases is a powerful way to amplify the "pay for performance" message. But it also can be tantamount to attempting to run higher voltages through old wires. If the performance management system is not sound and well accepted this approach should be used with caution. Using cash awards highlights differences in amounts allocated to individuals and it will raise emotions. Of course it is folly to attempt to administer any merit pay program with an inadequate performance management system. But in many cases people have accepted the way things work, albeit imperfectly… and will withdraw that acceptance when the stakes are raised. Notice how the good will and casual attitudes at family penny-ante poker games change when someone suggests a nickel-dime game.

In fact there are many pre-requisites for any merit pay program to work well. The first is that jobs are appropriately valued, both internally and with respect to prevailing market rates. If the salary range, which represents an employee's salary potential, is not both equitable and competitive then that will be the dominant issue. If the performance standards for the job are not clearly communicated in advance this will reduce the perception that the employee is being given a fair shot at performing well. If managers are not well trained in continuously measuring performance and providing feedback this will frustrate employees (the #1 factor impacting employee satisfaction and effectiveness in the Gallup poll was "knowing what is expected"). If managers do not determine the causes of good and poor performance and invest in employee development there will be a perception that employees are disposable parts. If managers do not honestly appraise performance based on job-related behaviors and results the system will not be effective. Finally, if a strong budgetary discipline is not in place managers may "go to bat" for their employees and either break the bank or rob other managers of resources. Once the rewards are clearly specified for performing at a given level the temptation to consider all of one's subordinates as "Outstanding" is very strong (how many times has "if they were not outstanding they could not work for me" been heard in the corridors… or "to be an executive in this organization you have to be outstanding").

Given all of these obstacles it is not surprising that many organizations have given up on their merit pay plans being effective. Unfortunately, they have no viable alternatives in most cases. Those Malcolm Baldridge Award winners mentioned earlier continue to use merit pay, with all of its imperfections, but they do other things as well. For example, they use person-based pay programs for those employees where it fits the nature of the work and of the workforce.

Person-Based Pay

There are many different manifestations of the concept of paying the person for what they bring to the organization, rather than what they happen to be doing at a given point in time. In the late 90's there was an outburst of claims that the holy grail had been found and that it was "competency-based pay." The euphoria has since declined but the attention focused on the possibility of paying the person at least in certain cases still exists. The literature binge also refocused organizations on behaviors as being a legitimate basis for measuring performance.

Unfortunately paying people based on what they could do rather than on what they produce can bankrupt the organization… unrealized potential is hard to turn into profits. And given the legal environment in the U.S. it is very risky to differentiate between people on any basis other than job-related results. Yet there are approaches to reconciling what seems to be a contradiction between pay for qualifications and paying for results.

There are three approaches to tying base pay to what people have in the way of qualifications: 1) skill-based, 2) knowledge-based and 3) credential-based.

Skill-based pay

Skill-based pay makes the base rate contingent on how many job-related skills the employee has learned, the level of skill mastery or a combination of both. For example, if a work unit requires that in aggregate the workforce must possess five skills (or skill sets) and management believes it is most effective to have most or all employees completely cross-skilled then pay might be based on the number of skills a person has. Someone entering the unit would start at the 0 skill rate and then progress to the five skill rate when mastery had been demonstrated in all five skills.

Experience has shown that average pay rates will go up under this system… good news for the employees. But if management utilizes the people well the staffing level can usually be reduced, since there is less wasted time due to the flexibility of the workforce to shift to meet the workflow. Therefore, total payroll may not increase, or even go down… good news for the organization. So skill-based pay can stimulate productivity and help control costs. But it is critical to use skill-based pay in contexts where it fits.

Some cultures reward longevity rather than performance or job mastery and this is often difficult to overcome. In such a culture skill-based pay is difficult to administer well, since managers will be reluctant to bypass individuals that do not master skills, particularly if this persists for an extended period. Moving relative “rookies” past “veterans,” even for the right reasons, is difficult. It is also difficult to retrofit a skill-based plan into a unit where longevity pay has prevailed, since people may be paid at levels that are inconsistent with their skill mastery. For this reason many of the skill-based pay systems have been installed in new “greenfield” entities.

There are other obstacles as well. There must be some “test” that determines skill mastery and there must be someone willing to administer that test and to stand behind it. Many skills are difficult to test directly, particularly in white collar and service-related jobs, and the test often boils down to someone’s judgment. And first line supervisors are reluctant to do the testing, given that everyone they fail will be miserable to be around. But if they pass everyone the system will not be viewed as having any teeth.

Knowledge-based pay

Knowledge-based pay typically centers around career ladders, which identify expertise levels within the same occupation or discipline. For example, Analysts at all levels of expertise perform work of the same basic level, but do so at varying levels of knowledge, skill and responsibility (see Exhibit 4). An Associate Analyst may be defined as a person possessing a B.S. degree in a related field and having 0-2 years of systems experience, while a Senior Analyst is expected to have an M.S. or equivalent technical training and 5-8 years of relevant experience. There will be other differences as well, to include the complexity of work they are expected to deal with, the amount of latitude they are given and the impact of their work on the unit effectiveness. This occupational/job “family” represents a career progression followed by most occupational members and progression through the levels happens at differing speeds, based on individual abilities and the manner in which they progress in their command of the knowledge in their field.

If the organization uses an integrated salary structure the levels within the family can be placed into job grades, based on relative internal equity and/or external market rates. The pay range for the grade assigned to each level becomes the range of pay opportunity for incumbents of that level, just as it does for other jobs. When an employee has developed to the extent that they more correctly belong in the next level, this can be treated as a promotion since the grade will be higher. Some argue that this is so similar to a job-based system using merit pay that it should be treated as such. The key distinction, however, is that employees are classified and progress based on their level of expertise, rather than on their specific job assignment. In effect, their pay opportunity is based on what they are capable of doing, rather than what they happen to be doing at the moment. For example, a Senior Engineer may operate as a worker bee on one project and then be the lead person on the next – but will always be a Senior.

Exhibit 4 **Analyst Career Ladder**

Job Criteria	*Associate Analyst*	*Analyst*	*Senior Analyst*
Nature of work (type; complexity; variety; difficulty; scope)	Performs varied assignments involving routine analytical work.	Performs a wide variety of relatively complex analytical work, ensuring schedule, budget and performance requirements are met. Must be able to perform multiple assignments simultaneously. May direct phases of a single revenue-producing project. May prepare customer quotations on routine jobs with clearly defined protocols.	Performs the full range of analytical work in a given area, including the most complex tests, ensuring schedule, budget and performance requirements are met and that the technical quality meets standards. Evaluates customer requests, determine testing requirements and prepare project quotations.
Latitude exercised/ Direction received (authority; nature & frequency of supervision received)	Under general supervision, works with established protocols, seeking assistance with unusual situations or when problems occur. Work is reviewed for technical soundness before it is sent to customer.	Under general direction, works with established protocols, seeking assistance with complex/difficult problems. Work may be sent to customer prior to its technical review.	Works independently with the full range of established protocols in a given area. Solves complex and difficult problems, assisting others as required. Work may be sent to customer prior to its technical review.
Creativity and ingenuity required	Exercises judgment in using defined procedures, in order to determine appropriate course of action.	Exercises discretion in selecting protocols to use. May recommend revisions to established protocols.	Develops improvements to established protocols and may create new methods and processes that improve productivity or expand capabilities.
Responsibility for interpersonal contacts (nature; level; frequency; impact)	Limited customer contact, involving the exchange of information and answering questions. Interacts with peers and internal support personnel to coordinate work	Contacts customers to define scope of work, to clarify information and to resolve issues.	Develops customer relationships to expand range of services provided and to maintain high level of satisfaction.
Responsibility for assets and information	Protects confidential information and proprietary processes. Handles materials and company equipment in a responsible and efficient manner	Protects confidential information and proprietary processes. Handles materials and company equipment in a responsible and efficient manner.	Protects confidential information and proprietary processes. Handles materials and company equipment in a responsible and efficient manner.
Responsibility for the work of others	May provide direction to support staff and technicians	Provides technical direction to support staff/ technicians; assists in training Analysts.	Provides technical direction to less experienced Analysts and assists in their training
Potential Impact (costs; quality; customer satisfaction; productivity)	Poor quality work or failure to obtain results may cause delays to schedules and require the expenditure of additional resources.	Erroneous decisions may cause loss of revenue, excessive costs and/or customer dissatisfaction.	Erroneous decisions typically cause loss of revenue, excessive costs and/or customer dissatisfaction.
Education/formal training & work experience required (type: level; duration)	BS or MS in science/ engineering or equivalent relevant experience.	BS in science/ engineering plus 4-5 years specifically related experience OR MS plus 2-3 years OR PhD with no experience. Experience should be in performing analytical testing with sophisticated equipment. Material characterization experience highly desirable.	BS in science/engineering plus 8-10 years specifically related experience OR MS plus 5-8 years OR PhD plus 2-5 years. Experience should be in performing analytical testing with sophisticated equipment. Material characterization experience highly desirable.

The vast majority of scientific, engineering and professional occupations lend themselves to this approach. Accounting/Finance, Legal, IT, Purchasing and HR are examples of disciplines with a defined body of knowledge that people formally train for and work within for most or all of their careers. As a result, their knowledge and expertise in their field grows over time and it becomes the metric for shaping their roles in their organizations. Since what an Engineer (or other professional) actually does over time varies so much it is difficult to use a "job-based" system to assign job grades and pay ranges and to make employees feel current duties are the appropriate metric for gauging their worth. In addition, professionals tend to be oriented more to their fields and their growth in those fields than to their employing organization. This argues strongly for the use of career metrics that are oriented to that field.

The use of merit pay is still a viable approach for administering salaries within the pay ranges. This raises the issue of whether this "person-based" system is really all that different from a conventional merit pay system. The real difference is the basis upon which the employee is classified (placed within the salary structure)… again, what the person is capable of doing determines their level, and therefore their grade, while what they are paid within the range is most often determined by a merit pay system.

Credential-based pay

A third person-based approach recognizes formal credentials as a basis for determining pay. Licenses, professional certifications, admission to the Bar and other such formal designations can act to do several things: 1) limit who can do certain kinds of work, thereby acting as a gatekeeping device to control occupational entry, 2) control who can be promoted to higher levels, and 3) act as the basis for paying differentials or lump sums that acknowledge the credential. Attorneys must be members of the Bar to represent the organization in court, Engineers must be licensed as PE's to sign off on bridge designs and people who obtain a professional certification (e.g., PHR or SPHR) may receive a differential for keeping it current and/or a lump sum upon receiving it. This approach is not a stand-alone approach to determining pay but can impact earnings in several ways.

Administering Base Pay Programs

Large organizations and those with occupationally diverse workforces may well choose several of the approaches to base pay rate determination already discussed. Although it could be argued that simplicity dictates using one approach for everyone that may result in the greatest administrative complexity. It is far easier to administer two or more programs that fit the groups of employees they are used for than it is to make one approach fit a variety of objectives and contexts. Sales and executive personnel have traditionally been covered by different compensation programs. As already mentioned many organizations use person-based approaches for professionals, even though they may use job-based systems for other employees. The differences will usually occur in the method used to define and value jobs/roles and to determine the range of pay opportunity. When it comes to administering individual pay rates merit pay is the dominant choice and is typically used for all employees.

There are a number of administrative issues that must be dealt with no matter which pay determination choice is used: 1) timing of pay actions, 2) administrative controls utilized, and 3) evaluating program effectiveness.

Timing of pay actions

Pay actions most often occur either on a single (focal) date or on anniversary dates throughout the year. Although there are arguments for both approaches the vast majority of organizations utilize the focal date approach. It enables managers to make pay action decisions at a time when they best know how well the organization/unit did, how well the employee did and what resources are available for pay actions. Another plus for using a focal date is that all decisions are made at the same time, making it easier for a manager to compare across employees, relative to both performance appraisals and pay actions. The single best argument for anniversary date is the workload that a manager may experience at a given time, but since no manager can know the performance of more than a few employees well enough to do an accurate appraisal, others will probably be involved, reducing the workload.

It is important that the timing of the performance appraisal and the salary action are coordinated. If an employee is to believe pay is tied to performance there must be a visible connection and long periods of time between the performance review and the salary action diminish the connection. Edward Lawler and others have used research to establish that employees view an appraisal as incomplete unless the consequences are made known as a part of the review process.

Administrative Controls Utilized

Pay ranges and pay increase budgets are the two most common control devices used for base pay administration. As described earlier when discussing merit pay it is critical to evaluate where pay rates fall within the pay ranges, in order to determine if the organization is acting in a manner consistent with its pay policy. Of particular concern to an organization are pay rates that fall below or above the pay range minimums or maximums, respectively.

Pay rates below the range minimums have a relatively simple solution… raise them. However the cost of this option is often outside the organization's ability to pay. During times of rapid market escalation much of the budget is used up just keeping people at their current position in the range, since the ranges must be adjusted significantly in order to keep them competitive. The late 90's saw average market rates for people with certain Information Technology skills escalate dramatically, often by more than budgetary constraints would allow organizations to increase their pay rates. Those organizations that limited range adjustments so that actual rates would not fall below the minimum found during the next year that their pay structures had fallen even further behind market.

This dilemma could have been solved for many organizations through the use of outside contractors, to perform the "heavy lifting" associated with implementing new network systems, rather than bringing legacy mainframe systems into compliance with Y2K requirements. Since conversions to new systems are primarily a one-time effort this approach could have limited the degree to which many organizations would have had to compete for scarce skills and this probably would have reduced the amount of temporary salary inflation. This experience has caused a lot of employers to question whether they must always be fully at market, no matter the cost, and perhaps to look more favorably at developing current employees through training as an alternative to competing in unbalanced labor markets.

Pay rates that are above the range maximums are a much more difficult situation to correct than pay rates below minimums. Base pay is only flexible in an upward direction – to cut someone's wage or salary is typically viewed as an extreme act of aggression. So rates that are significantly above a maximum are going to take time to fix and the fix is often difficult. Freezing the base pay of an employee who has gotten increases every year for an extended period is a tough thing to do, particularly if the employee is performing at or above expectations. It makes things easier if the organization has had the "we pay for performance, not give increases for performance" discussion described earlier but it still is a difficult situation when it occurs. An employee who knows their pay is frozen, perhaps for more than one year, has no economic incentive to perform at the highest level possible, and in fact may be motivated to play it safe to protect the job and the income stream.

Increasingly organizations are adopting performance-based cash incentives for people at or over their range maximum, to motivate them to high levels of performance. An example might be: no award for someone who meets standards, a modest cash award for someone who significantly exceeds standards and a large cash award for outstanding performance. The pay rate is not affected and as the pay ranges are adjusted the maximum will catch the pay rate, assuming the person stays employed long enough. The author installed a new pay plan in an investment firm and the pay of a long service employee was 30% over the range maximum. Given that the employee was already middle aged and that structures rarely move more than 4-5% even in the wildest times, it was unlikely the maximum would have caught up before retirement.

Organizations should consider the consequences of not taking action to adjust salaries when situations occur that would cause a pay rate to be substantially above the range maximum. Often someone who fails in a management position is moved back in the ranks but no adjustment is made to the pay. Although this seems to be the humane approach it creates difficult situations and this should be anticipated.

Budgets are a useful way of controlling overall pay levels, since they limit the increase to the fixed payroll. Unfortunately they raise significant administrative issues. The most common practice is to settle on an amount (e.g., 4% of payroll) that can be used for increases (the amount may or may not include promotional increases) and to give each unit the same percentage of their current payroll. But often there will be large differences across organizational units relative to where pay rates fall within the pay structure. A unit that has experienced considerable turnover may have a large percentage of its employees in the lower part of the range, given that they are still new and learning their jobs. But if that unit only has 4% of its (relatively small) payroll it will have a difficult time funding the larger percentage increases prescribed by merit increase guidelines such as those illustrated in Exhibit 1. On the other hand, another unit with a mature workforce may have most of their employees in the middle or upper third of the range and only need a smaller percentage of current pay. But that unit will have a <u>larger</u> dollar pool, since 4% of their larger payroll produces a bigger fund. So management is faced with giving one unit inadequate funds relative to need while overfunding another. Expecting the overfunded unit to offer some of their budget to the ailing unit is probably seriously delusional, so some type of correction is called for.

A *compa-ratio* is a measure that expresses current pay rates as a percentage of range midpoints. For an individual at the midpoint of the range the compa-ratio is 1.0, while someone at the minimum might have a compa-ratio of 0.8 and someone at maximum a compa-ratio of 1.2. This measure is generated in most HR Information System packages since it is a handy way of monitoring actual pay rates against intent (range midpoints) and it can be calculated at the unit level as well. This measure can be used to adjust the out of line budget allocations just discussed. If the allocated 4% fund for each unit were to be divided by its compa-ratio this would result in an allocation better fitted to "need" and would avoid asking for voluntary give-ups of funds. Because units with compa-ratios of less than 1.0 will have their funds increased and those with compa-ratios greater than 1.0 will have theirs decreased a greater balance with need for increases can be achieved. Of course the argument will be made that people in the unit with the high salaries are better performers and should get larger increases and that needs to be considered and dealt with.

Budgets are a constraint imposed by the organization's ability to pay and may conflict with what the organization feels it should spend on increases. But this does not diminish the usefulness of having policies and programs that incorporate sound principles, since they will result in the optimal allocation of what is available.

Evaluating Base Pay System Effectiveness

The best test of a pay system's overall effectiveness is whether it produces the desired results. If the organization is able to get and keep the critical skills it needs to function and if the workforce performs well it is logical to infer that the pay system is working, or at least not impeding effectiveness. As compensation practitioners read about the new fad that has broken out in the field there is a temptation to try it, to see if it will improve performance. However, employees tend to control their enthusiasm for frequent pay system modifications, and in fact get testy if it seems the organization is floundering. It is therefore important to consider the impact of revising the pay program vs. refining the existing program to increase its effectiveness.

There are two dimensions of program effectiveness: perceptions and realities. What employees believe about the programs (How fair is it? How competitive?) will determine how they feel about it and how they react. It is therefore important that those responsible for program administration do not respond to employee claims that they are not being paid fairly or competitively with "they are wrong." They may be, but it is critical that HR change their minds if this is the case, since perception is reality for an employee. Attitude surveys, focus groups and other forms of dialogue can help HR understand what the prevailing beliefs are and enable them to use training or improved communication.

How well a program really does function is also critical. There are numerous evaluation questions to be asked:

1. Do employees know what is expected? Is job documentation accurate?
2. Are employees correctly classified into jobs?
3. Do job grade assignments reflect internal equity?
4. Are pay ranges competitive, based on the desired competitive posture?
5. Are performance ratings fair and accurate?
6. Do performance ratings accurately reflect contribution, irrespective of the age, race, gender or other personal characteristics of employees?
7. Do the pay increase guidelines reflect pay philosophy?
8. Are individual pay actions tied to performance, irrespective of the age, race, gender or other personal characteristics of emplyees?
9. Do increases stay within the established budget?
10. Are employee appeals given the appropriate attention?
11. Is the base pay program adequately integrated with other programs?

If deficiencies are found when performing audits it is important to acknowledge them, address them and communicate why any changes that are made are necessary. HR may wish to have people from outside the function do periodic audits, in order to dispel the suspicion that the designers of the programs are defensive about acknowledging inadequacies. A task force representing a horizontal slice of the organization can lend credibility to the evaluation process and it may be advisable to involve people representing a vertical cross-section as well. Edward Lawler (already credited earlier) has been providing research results showing the adverse effects of pay secrecy for decades. His research argues for opening up all policies and processes to public scrutiny, although individual pay rates and pay actions should still remain a matter between an employee and the organization. Sunshine kills a lot of viruses and pay systems have too often been administered under a fog bank.

Given the legal/regulatory environment in the U.S. one of the major concerns about pay administration is its impact on classes of employees. If audits find that one class of employee gets lower performance ratings and/or smaller increases while otherwise similarly situated this may establish adverse impact and may require justification. If there are unexplained differences they should be investigated, regardless of the probability of legal action. Pay should be correlated to the value of the job/role, the mastery level and performance… nothing else. If this is not the case the policies and programs need examination. However, if females get lower performance ratings on average than males it may be due to actual differences in performance, so there should not be a premature assumption of mismanagement. To accuse a manager of gender bias is a very serious indictment, especially if it is unwarranted. On the other hand, if the bias exists, even if it is unintentional, other steps need to be take to ensure the end result of the system is equitable and consistent with policy. As mentioned earlier perception is reality to employees and it is wise to ensure there is confidence in the administration of the pay program.

Conclusion

Base pay is the foundation of the compensation package. How well base pay programs are designed and administered will have a major impact on the organization's ability to attract and retain the skills critical to its success. If base pay is administered in a manner that is viewed as equitable, competitive and performance-based it will facilitate meeting organizational objectives. The importance of base pay should not be underestimated. To give up on the concept of merit pay just because it is difficult and frustrating to administer a program well is sheer folly. It is not a viable option.

Every HR practitioner, whether compensation specialist or generalist, has a stake in having the base pay programs of the organization be well designed and administered. In order to be able to contribute to effectiveness each practitioner must understand the concepts and principles underlying the organization's programs… and be knowledgeable about alternative approaches and competitive practices. In addition to being knowledgeable practitioners must be involved and be diligent, to ensure that what is intended is what actually occurs throughout the organization.