chapter 11

Establishing a Pay Structure

What Do I Need to Know?

After reading this chapter, you should be able to:

- LO1 Identify the kinds of decisions involved in establishing a pay structure.
- LO2 Summarize legal requirements for pay policies.
- LO3 Discuss how economic forces influence decisions about pay.
- LO4 Describe how employees evaluate the fairness of a pay structure.
- LO5 Explain how organizations design pay structures related to jobs.
- LO6 Describe alternatives to job-based pay.
- LO7 Summarize how to ensure that pay is actually in line with the pay structure.
- LO8 Discuss issues related to paying employees serving in the military and paying executives.

Introduction

Competition among law firms to get the best new lawyers has been so stiff that salaries have been rising year after year. Traditionally, firms pay them according to their years out of school; the longer the associates have been working, the more they earn. So when a company raises associate salaries, it is raising them for everyone—an expensive move. Recently, however, some law firms have broken that mold and are tying pay more closely to what each associate contributes to the firm. For example, in San Diego, the firm Luce, Forward, Hamilton & Scripps set up 14 pay levels related to the associate's productivity (some work more hours than others) and practice area (some types of legal work are more profitable than others). Some recruiters question whether the new system will seem less fair, identifying some lawyers as having a less-valuable practice. The firm argues that its pay levels offer a wider range of opportunities for lawyers who might prefer to work fewer hours or in a less-profitable area. With the new system, hiring these lawyers becomes affordable.[1]

From the employer's point of view, pay is a powerful tool for meeting the organization's goals. Pay has a large impact on employee attitudes and behaviors. It influences which kinds of employees are attracted to (and remain with) the organization. By rewarding certain behaviors, it can align employees' interests with the organization's goals. Employees care about policies affecting earnings because the policies affect the employees' income and standard of living. Besides the level of pay, employees care about its fairness compared with what others earn. Also, employees consider pay a sign of status and success. They attach great importance to pay decisions when they evaluate their relationship with their employer. For these reasons, organizations must carefully manage and communicate decisions about pay.

At the same time, pay is a major cost. Its share of total costs varies widely from one industry or company to another. At the low end, the wholesaling industry spends over 5 percent of revenues on payroll expenses. At the other extreme, transportation, entertainment, and health care companies spend more than 25 percent to almost 40 percent of revenues on payroll.[2] Managers have to keep this cost reasonable.

This chapter describes how managers weigh the importance and costs of pay to arrive at a structure for compensation and levels of pay for different jobs. We first define the basic decisions in terms of pay structure and pay level. Next, we look at several considerations that influence these decisions: legal requirements related to pay, economic forces, the nature of the organization's jobs, and employees' judgments about the fairness of pay levels. We describe methods for evaluating jobs and market data to arrive at a pay structure. We then summarize alternatives to the usual focus on jobs. The chapter closes with a look at two issues of current importance—pay for employees on leave to serve in the military and pay for executives.

Decisions about Pay

LO1 Identify the kinds of decisions involved in establishing a pay structure.

Because pay is important both in its effect on employees and on account of its cost, organizations need to plan what they will pay employees in each job. An unplanned approach, in which each employee's pay is independently negotiated, will likely result in unfairness, dissatisfaction, and rates that are either overly expensive or so low that positions are hard to fill. Organizations therefore make decisions about two aspects of pay structure: job structure and pay level. **Job structure** consists of the relative pay for different jobs within the organization. It establishes relative pay among different functions and different levels of responsibility. For example, job structure defines the difference in pay between an entry-level accountant and an entry-level assembler, as well as the difference between an entry-level accountant, the accounting department manager, and the organization's comptroller. **Pay level** is the average amount (including wages, salaries, and bonuses) the organization pays for a particular job. Together, job structure and pay levels establish a **pay structure** that helps the organization achieve goals related to employee motivation, cost control, and the ability to attract and retain talented human resources. These decisions are supplemented with choices about payroll methods such as the ones described in the "eHRM" box.

Job Structure
The relative pay for different jobs within the organization.

Pay Level
The average amount (including wages, salaries, and bonuses) the organization pays for a particular job.

Pay Structure
The pay policy resulting from job structure and pay-level decisions.

The organization's job structure and pay levels are policies of the organization, rather than the amount a particular employee earns. For example, an organization's pay structure could include the range of pay that a person may earn in the job of entry-level accountant. An individual accountant could be earning an amount anywhere within that range. Typically, the amount a person earns depends on the individual's qualifications, accomplishments, and experience. The individual's pay may also depend partly on how well the organization performs. This chapter focuses on the organization's decisions about pay structure, and the next chapter will explore decisions that affect the amount of pay an individual earns.

Especially in an organization with hundreds or thousands of employees, it would be impractical for managers and the human resource department to make an entirely unique decision about each employee's pay. The decision would have to weigh so many factors that this approach would be expensive, difficult, and often unsatisfactory. Establishing a pay structure simplifies the process of making

eHRM

focus on **social responsibility**

PAYING EMPLOYEES ELECTRONICALLY

Walmart recently began implementing a system to pay all of its Walmart and Sam's Club workers in the United States electronically. While management and professional employees have long participated in electronic payment programs where funds are automatically deposited in each employee's checking account on payday, low-wage employees such as sales clerks do not always have checking accounts.

Walmart's solution was to team up with First Data Management Company to provide hourly employees with MasterCard Paycards. These cards look like credit cards, but instead of being linked to credit, these accounts are funded by the employee's pay. Instead of receiving a paper check that they have to cash, employees have funds automatically credited to their Paycard. Employees can shop with their cards, get cash at an ATM, or use their cards to make a purchase with cash back. Because the funds are deposited electronically, an employee gets paid immediately on payday, even if the employee isn't at work that day. Employees also can opt for direct deposit if they have a bank account.

Walmart instituted the electronic payroll program as part of its effort to make the company more environmentally friendly. Because the company has over a million employees, it saves a substantial amount of paper by not stuffing paychecks into envelopes.

Sources: "Walmart Launches Associate Electronic Pay Program," *Progressive Grocer*, September 4, 2009, Business & Company Resource Center, http://galenet.galegroup.com; "With 1.4 Million Employees, Wal-Mart Puts Payroll Cards on the Map," *Digital Transactions*, September 3, 2009, www.digitaltransactions.net; and First Data, "First Data: Money Network," corporate website, www.firstdata.com, accessed April 21, 2010.

decisions about individual employees' pay by grouping together employees with similar jobs. As shown in Figure 11.1, human resource professionals develop this pay structure based on legal requirements, market forces, and the organization's goals, such as attracting a high-quality workforce and meeting principles of fairness.

Figure 11.1

Issues in Developing a Pay Structure

Legal Requirements for Pay

LO2 Summarize legal requirements for pay policies.

Government regulation affects pay structure in the areas of equal employment opportunity, minimum wages, pay for overtime, and prevailing wages for federal contractors. All of an organization's decisions about pay should comply with the applicable laws.

Equal Employment Opportunity

Under the laws governing Equal Employment Opportunity, described in Chapter 3, employers may not base differences in pay on an employee's age, sex, race, or other protected status. Any differences in pay must instead be tied to such business-related considerations as job responsibilities or performance. The goal is for employers to provide *equal pay for equal work.* Job descriptions, job structures, and pay structures can help organizations demonstrate that they are upholding these laws.

These laws do not guarantee equal pay for men and women, whites and minorities, or any other groups, because so many legitimate factors, from education to choice of occupation, affect a person's earnings. In fact, numbers show that women and racial minorities in the United States tend to earn less than white men. Among full-time workers in 2008, women on average earned 80 cents for every dollar earned by men. Among male employees, black workers earned 85 cents for every dollar earned by white workers, and Hispanic workers earned just 76 cents (the racial gap among Black and Hispanic female employees is greater, at 76 and 66 cents per dollar, respectively).[3] Even when these figures are adjusted to take into account education, experience, and occupation, the earnings gap does not completely close.[4]

One explanation for historical lower pay for women has been that employers have undervalued work performed by women—in particular, placing a lower value on occupations traditionally dominated by women. Some policy makers have proposed a remedy for this called equal pay for *comparable worth.* This policy uses job evaluation (described later in the chapter) to establish the worth of an organization's jobs in terms of such criteria as their difficulty and their importance to the organization. The employer then compares the evaluation points awarded to each job with the pay for each job. If jobs have the same number of evaluation points, they should be paid equally. If they are not, pay of the lower-paid job is raised to meet the goal of comparable worth.

Comparable-worth policies are controversial. From an economic standpoint, the obvious drawback of such a policy is that raising pay for some jobs places the employer at an economic disadvantage relative to employers that pay the market rate. In addition, a free-market economy assumes people will take differences in pay into account when they choose a career. The courts allow organizations to defend themselves against claims of discrimination by showing that they pay the going market rate.[5] Businesses are reluctant to place themselves at an economic disadvantage, but many state governments adjust pay to achieve equal pay for comparable worth. Also, at both private and government organizations, policies designed to shatter the "glass ceiling" (discussed in Chapter 9) can help to address the problem of unequal pay.

Two employees who do the same job cannot be paid different wages because of gender, race, or age. It would be illegal to pay these two employees differently because one is male and the other is female. Only if there are differences in their experience, skills, seniority, or job performance are there legal reasons why their pay might be different.

Minimum Wage

Minimum Wage
The lowest amount that employers may pay under federal or state law, stated as an amount of pay per hour.

Fair Labor Standards Act (FLSA)
Federal law that establishes a minimum wage and requirements for overtime pay and child labor.

In the United States, employers must pay at least the **minimum wage** established by law. (A *wage* is the rate of pay per hour.) At the federal level, the 1938 **Fair Labor Standards Act (FLSA)** establishes a minimum wage that is $7.25 per hour as of July 2009. The FLSA also permits a lower "training wage," which employers may pay to workers under the age of 20 for a period of up to 90 days. This subminimum wage is approximately 85 percent of the minimum wage. Some states have laws specifying minimum wages; in these states, employers must pay whichever rate is higher.

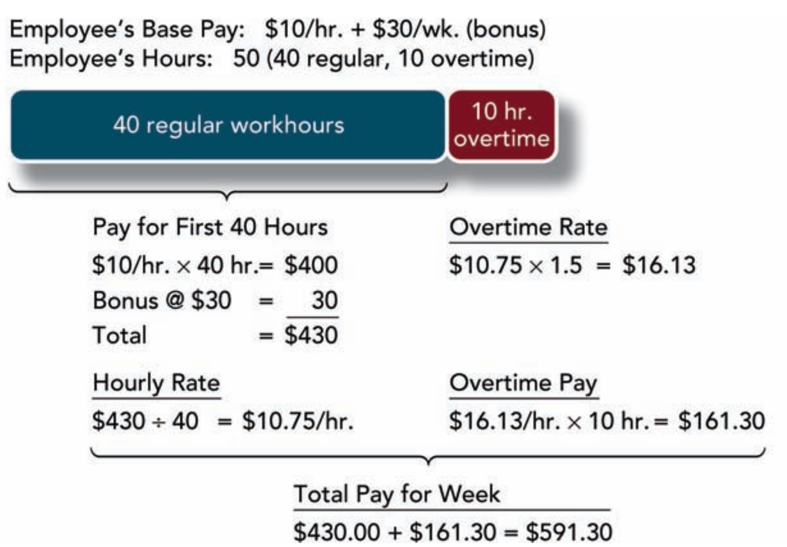
From the standpoint of social policy, an issue related to the minimum wage is that it tends to be lower than the earnings required for a full-time worker to rise above the poverty level. A number of cities have therefore passed laws requiring a so-called *living wage*, essentially a minimum wage based on the cost of living in a particular region.

Overtime Pay

Another requirement of the FLSA is that employers must pay higher wages for overtime, defined as hours worked beyond 40 hours per week. The overtime rate under the FLSA is one and a half times the employee's usual hourly rate, including any bonuses and piece-rate payments (amounts paid per item produced). The overtime rate applies to the hours worked beyond 40 in one week. Time worked includes not only hours spent on production or sales but also time on such activities as attending required classes, cleaning up the work site, or traveling between work sites. Figure 11.2 shows how this applies to an employee who works 50 hours to earn a base rate of $10 per hour plus a weekly bonus of $30. The overtime pay is based on the base pay ($400) plus the bonus ($30), for a rate of $10.75 per hour. For each of the 10 hours of overtime, the employee would earn $16.13, so the overtime pay is $161.30 ($16.13 times 10). When employees are paid per unit produced or when they receive a monthly or quarterly bonus, those payments must be converted into wages per hour, so that the employer can include these amounts when figuring the correct overtime rate.

Overtime pay is required, whether or not the employer specifically asked or expected the employee to work more than 40 hours.[6] In other words, if the employer knows the

Figure 11.2
Computing Overtime Pay



HR Oops!

Booting Up Your Computer Is Work, Too

Qwest Communications recently got in trouble when employees in its call center sued for unpaid overtime. Employees said they weren't being paid for starting work before their shifts officially began. Why did they do that? In some cases, they said, their managers asked them to come in before the start of their shift and start up their computers. In other cases, their daily job requirements were so challenging that the only way to meet the goals was for the computers to be up and running when their shift began.

Qwest defended itself on the grounds that it had a policy forbidding employees to work off the time clock. But the judge in the case said the company's actual practices, not the policy, were what the jury would need to consider.

Companies that don't want to pay overtime rates for booting up computers have to build that work into employees' scheduled activities.

Questions

1. Why do you think the managers at Qwest didn't seem to think of getting computers started as part of the employees' work?
2. How could HR professionals prevent this sort of misunderstanding?

Source: Based on "Workers Coming in Early to Fire Up Their Computers? You Must Pay Them," *HR Specialist: Employment Law,* March 2010, Business & Company Resource Center, http://galenet.galegroup.com.

employee is working overtime but does not pay time and a half, the employer may be violating the FLSA (see the "HR Oops!" box for an example).

Not everyone is eligible for overtime pay. Under the FLSA, executive, professional, administrative, and highly compensated white-collar employees are considered **exempt employees,** meaning employers need not pay them one and a half times their regular pay for working more than 40 hours per week. Exempt status depends on the employee's job responsibilities, salary level (at least $455 per week), and "salary basis," meaning that the employee is paid a given amount regardless of the number of hours worked or quality of the work.[7] Paying an employee on a salary basis means the organization expects that this person can manage his or her own time to get the work done, so the employer may deduct from the employee's pay only in certain limited circumstances, such as disciplinary action or for unpaid leave for personal reasons. Additional exceptions apply to certain occupations, including outside salespersons, teachers, and computer professionals (if they earn at least $27.63 per hour). Thus, the standards are fairly complicated. For more details about the standards for exempt employees, contact the Labor Department's Wage and Hour Division or refer to its Web site at www.dol.gov/whd.

Exempt Employees
Managers, outside salespeople, and any other employees not covered by the FLSA requirement for overtime pay.

Any employee who is not in one of the exempt categories is called a **nonexempt employee.** Most workers paid on an hourly basis are nonexempt and therefore subject to the laws governing overtime pay. However, paying a salary does not necessarily mean a job is exempt.

Nonexempt Employees
Employees covered by the FLSA requirements for overtime pay.

Child Labor

In the early years of the Industrial Revolution, employers could pay low wages by hiring children. The FLSA now sharply restricts the use of child labor, with the aim of protecting children's health, safety, and educational opportunities.[8] The restrictions apply to children younger than 18. Under the FLSA, children aged 16 and 17 may not be employed in hazardous occupations defined by the Department of Labor, such as mining, meatpacking, and certain kinds of manufacturing using heavy machinery. Children aged 14 and 15 may work only outside school hours, in jobs defined as nonhazardous, and for limited time periods. A child under age 14 may not be employed in any work associated with interstate commerce, except work performed in a nonhazardous job for a business entirely owned by the child's parent or guardian. A few additional exemptions from this ban include acting, babysitting, and delivering newspapers to consumers.

Besides the FLSA, state laws also restrict the use of child labor. Many states have laws requiring working papers or work permits for minors, and many states restrict the number of hours or times of day that minors aged 16 and older may work. Before hiring any workers under the age of 18, employers must ensure they are complying with the child labor laws of their state, as well as the FLSA requirements for their industry.

Prevailing Wages

Two additional federal laws, the Davis-Bacon Act of 1931 and the Walsh-Healy Public Contracts Act of 1936, govern pay policies of federal contractors. Under these laws, federal contractors must pay their employees at rates at least equal to the prevailing wages in the area. The calculation of prevailing rates must be based on 30 percent of the local labor force. Typically, the rates are based on relevant union contracts. Pay earned by union members tends to be higher than the pay of nonunion workers in similar jobs, so the effect of these laws is to raise the lower limit of pay an employer can offer.

These laws do not cover all companies. Davis-Bacon covers construction contractors that receive more than $2,000 in federal money. Walsh-Healy covers all government contractors receiving $10,000 or more in federal funds.

LO3 Discuss how economic forces influence decisions about pay.

Economic Influences on Pay

An organization cannot make spending decisions independent of the economy. Organizations must keep costs low enough that they can sell their products profitably, yet they must be able to attract workers in a competitive labor market. Decisions about how to respond to the economic forces of product markets and labor markets limit an organization's choices about pay structure.

Product Markets

The organization's *product market* includes organizations that offer competing goods and services. In other words, the organizations in a product market are competing to serve the same customers. To succeed in their product markets, organizations must be able to sell their goods and services at a quantity and price that will bring them a sufficient profit. They may try to win customers by being superior in a number of areas, including quality, customer service, and price. An important influence on price is the cost to produce the goods and services for sale. As we mentioned earlier, the cost of labor is a significant part of an organization's costs.

If an organization's labor costs are higher than those of its competitors, it will be under pressure to charge more than competitors charge for similar products. If one company spends $50 in labor costs to make a product and its competitor spends only

$35, the second company will be more profitable unless the first company can justify a higher price to customers. This is one reason U.S. automakers have had difficulty competing against Japanese companies. The labor-related expenses per vehicle for a U.S. company have been as much as $1,000 higher than for Japanese car makers operating in the United States. As that competitive disadvantage contributed to slower sales, U.S. producers have persuaded unions to let them reduce hourly labor costs, bringing them much closer in line with Japanese car makers.[9]

Product markets place an upper limit on the pay an organization will offer. This upper limit is most important when labor costs are a large part of an organization's total costs and when the organization's customers place great importance on price. Organizations that want to lure top-quality employees by offering generous salaries therefore have to find ways to automate routine activities (so that labor is a smaller part of total costs) or to persuade customers that high quality is worth a premium price. Organizations under pressure to cut labor costs may respond by reducing staff levels, freezing pay levels, postponing hiring decisions, or requiring employees to bear more of the cost of benefits such as insurance premiums.

Labor Markets

Besides competing to sell their products, organizations must compete to obtain human resources in *labor markets*. In general, workers prefer higher-paying jobs and avoid employers that offer less money for the same type of job. In this way, competition for labor establishes the minimum an organization must pay to hire an employee for a particular job. If an organization pays less than the minimum, employees will look for jobs with other organizations.

An organization's competitors in labor markets typically include companies with similar products and companies in other industries that hire similar employees. For example, a truck transportation firm would want to know the pay earned by truck drivers at competing firms as well as truck drivers for manufacturers that do their own shipping, drivers for moving and storage companies, and drivers for stores that provide delivery services. In setting pay levels for its bookkeepers and administrative assistants, the company would probably define its labor market differently, because bookkeepers and administrative assistants work for most kinds of businesses. The company would likely look for data on the earnings of bookkeepers and administrative assistants in the region. For all these jobs, the company wants to know what others are paying so that it will pay enough to attract and keep qualified employees. The "Did You Know?" box compares average pay levels for some broad occupational categories in the United States.

Another influence on labor markets is the *cost of living*—the cost of a household's typical expenses, such as house payments, groceries, medical care, and gasoline. In some parts of the country, the cost of living is higher than in others, so the local labor markets there will likely demand higher pay. Also, over time, the cost of living tends to rise. When the cost of living is rising rapidly, labor markets demand pay increases. The federal government

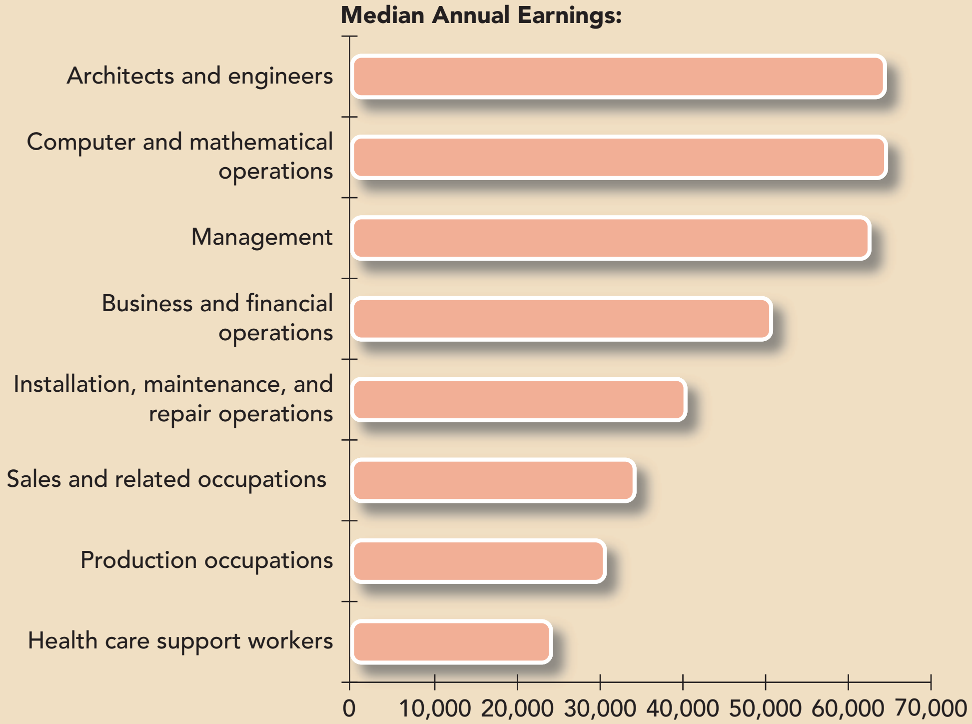
There is a strong demand for nurses in the labor market. What this means for hospitals is that they have to pay competitive wages and other perks to attract and retain staff. How does this differ from the airline industry's current labor market?

Did You Know?

Tech Workers Out-Earn Managers

Looking at broad occupational categories, people in technology-related jobs are some of the nation's top earners. The pay rates are for the *median* worker in each category (half the employees earn more and half earn less).

Source: U.S. Census Bureau, *Statistical Abstract of the United States: 2010,* Table 633, www.census.gov.



tracks trends in the nation's cost of living with a measure called the Consumer Price Index (CPI). Following and studying changes in the CPI can help employers prepare for changes in the demands of the labor market.

Pay Level: Deciding What to Pay

Although labor and product markets limit organizations' choices about pay levels, there is a range within which organizations can make decisions.[10] The size of this range depends on the details of the organization's competitive environment. If many workers are competing for a few jobs, employers will have more choice. Similarly, employers can be more flexible about pay policies if they use technology and work design to get better results from employees than their competitors do.

When organizations have a broad range in which to make decisions about pay, they can choose to pay at, above, or below the rate set by market forces. Economic theory holds that the most profitable level, all things being equal, would be at the market rate. Often, however, all things are not equal from one employer to another. For instance, an organization may gain an advantage by paying above the market rate if it uses the higher pay as one means to attract top talent and then uses these excellent employees' knowledge to be more innovative, produce higher quality, or work more efficiently. For example, Costco has a practice of paying its employees higher wages and more generous benefits than Walmart pays employees of Costco's chief competitor, Sam's Club. In return for this apparent generosity, Costco enjoys a much lower rate of employee turnover, potentially saving the company hundreds of millions of dollars a year. Costco also earns higher profits per hourly employee and loses less to "shrinkage" (employee theft).[11]

This approach is based on the view of employees as resources. Higher pay may be an investment in superior human resources. Having higher labor costs than your competitors is not necessarily bad if you also have the best and most effective workforce, which produces more products of better quality. Pay policies are one of the most important human resource tools for encouraging desired employee behaviors and discouraging undesired behaviors. Therefore, organizations must evaluate pay as more than a cost, but also as an investment that can generate returns in attracting, retaining, and motivating a high-quality workforce. For this reason, paying above the going rate may be advantageous for an organization that empowers employees or that cannot closely watch employees (as with repair technicians who travel to customers). Those employers might use high pay to attract and retain top candidates and to motivate them to do their best because they want to keep their high-paying jobs.[12]

Gathering Information about Market Pay

To compete for talent, organizations use **benchmarking,** a procedure in which an organization compares its own practices against those of successful competitors. In terms of compensation, benchmarking involves the use of pay surveys. These provide information about the going rates of pay at competitors in the organization's product and labor markets. An organization can conduct its own surveys, but the federal government and other organizations make a great deal of data available already.

Benchmarking
A procedure in which an organization compares its own practices against those of successful competitors.

Pay surveys are available for many kinds of industries (product markets) and jobs (labor markets). The primary collector of this kind of data in the United States is the Bureau of Labor Statistics, which conducts an ongoing National Compensation Survey measuring wages, salaries, and benefits paid to the nation's employees. The "HR How To" box provides guidelines for using the BLS Web site as a source of wage data. The most widely used sources of compensation information include HR organizations such as WorldatWork and the Society for Human Resource Management.[13] In addition, many organizations, especially large ones, purchase data from consulting groups such as Mercer, Salary.com, and Hewitt. Consulting firms charge for the service but can tailor data to their clients' needs. Employers also should investigate what compensation surveys are available from any industry or trade groups their company belongs to.

Human resource professionals need to determine whether to gather data focusing on particular industries or on job categories. Industry-specific data are especially relevant for jobs with skills that are specific to the type of product. For jobs with skills that can be transferred to companies in other industries, surveys of job classifications will be more relevant.

HR How To

GATHERING WAGE DATA AT THE BLS WEB SITE

A convenient source of data on hourly wages is the wage query system of the Bureau of Labor Statistics (BLS). This federal agency makes data available at its Web site on an interactive basis. The data come from the BLS's National Compensation Survey. The user specifies the category of data desired, and the BLS provides tables of data almost instantly. Here's how to use the BLS system.

Visit the BLS Web site (www.bls.gov), and click on the link to Pay & Benefits. Find and click on the link to the National Compensation Survey (NCS). On the NCS Web page, click on NCS Databases. You have a choice to use different tools to view various databases. The single-screen data search lets you define on one pop-up screen all the categories you want to include, while the multi-screen search asks you to specify one search category at a time, then click to open the next screen. The single-screen approach is faster, but as of this writing, that option was not yet available for the current NCS data, so these guidelines assume you are using the multiscreen search.

After you select Multi-Screen Data Search for NCS, the system presents you with a window in which to select either the entire United States or a single state. Click to highlight your choice and then click on Next Form. If you choose United States, your next choice is a Census region of the country; if you choose a state, the next option is a metropolitan region of the state.

On the next screen, select the occupation you wish to research. The survey data cover hundreds of occupations, grouped into more general categories. For example, at the most specific level, you could look at civil engineers. More broadly, you could look at all engineers, or at the larger grouping of architecture and engineering occupations. You should select the most specific grouping that covers the occupation you want to investigate. If you select occupation first, you can then select geographic areas for which the database includes data on that occupation.

After selecting an occupation, select a work level. This describes the level of such work features as knowledge required and the scope, complexity, and demands of the job. For instance, you could look only at data for entry-level or senior accountants, rather than all accountants. Some occupations, including artists, athletes, and announcers, are not classified by work level.

Click on the Retrieve Data link to submit the request to the BLS. The system immediately processes the request and presents the table (or tables) on your computer screen.

Source: Bureau of Labor Statistics Web site, www.bls.gov, accessed April 21, 2010.

LO4 Describe how employees evaluate the fairness of a pay structure.

Employee Judgments about Pay Fairness

In developing a pay structure, it is important to keep in mind employees' opinions about fairness. After all, one of the purposes of pay is to motivate employees, and they will not be motivated by pay if they think it is unfair.

Judging Fairness

Employees evaluate their pay relative to the pay of other employees. Social scientists have studied this kind of comparison and developed *equity theory* to describe how people make judgments about fairness.[14] According to equity theory, people measure outcomes such as pay in terms of their inputs. For example, an employee might think of her pay in terms of her master's degree, her 12 years of experience, and her 60-hour workweeks. To decide whether a level of pay is equitable, the person compares her ratio of outcomes and inputs with other people's outcome/input ratios, as shown in Figure 11.3. The person in the previous example might notice that an employee with

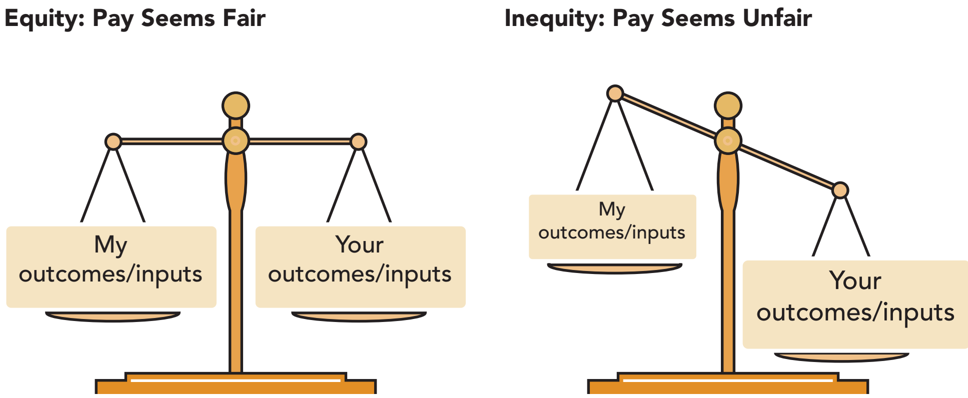


Figure 11.3

Opinions about Fairness: Pay Equity

less education or experience is earning more than she is (unfair) or that an employee who works 80 hours a week is earning more (fair). In general, employees compare their pay and contributions against several yardsticks:

- What they think employees in other organizations earn for doing the same job.
- What they think other employees holding different jobs within the organization earn for doing work at the same or different levels.
- What they think other employees in the organization earn for doing the same job as theirs.

Employees' conclusions about equity depend on what they choose as a standard of comparison. The results can be surprising. For example, some organizations have set up two-tier wage systems as a way to cut labor costs without cutting employees' existing salaries. Typically, employers announce these programs as a way to avoid moving jobs out of the country or closing down altogether. In a two-tier wage system, existing employees continue on at their current (upper-tier) pay rate while new employees sign on for less pay (the lower tier). One might expect reaction among employees in the lower tier that the pay structure is unfair. But a study of these employees found that they were *more* satisfied than the top-tier employees.[15] The lower-tier employees were not comparing their pay with that of the upper-tier employees but with the other alternatives they saw for themselves: lower-paying jobs or unemployment.

The ways employees respond to their impressions about equity can have a great impact on the organization. Typically, if employees see their pay as equitable, their attitudes and behavior continue unchanged. If employees see themselves as receiving an advantage, they usually rethink the situation to see it as merely equitable. But if employees conclude that they are underrewarded, they are likely to make up the difference in one of three ways. They might put forth less effort (reducing their inputs), find a way to increase their outcomes (for example, stealing), or withdraw by leaving the organization or refusing to cooperate. Employees' beliefs about fairness also influence their willingness to accept transfers or promotions. For example, if a job change involves more work, employees will expect higher pay.

Communicating Fairness

Equity theory tells organizations that employees care about their pay relative to what others are earning and that these feelings are based on what the employees *perceive* (what they notice and form judgments about). An organization can do much to

Best Practices

HOBBY LOBBY INSPIRES WITH GOOD NEWS ABOUT PAY

The Hobby Lobby chain of crafts stores operates under a philosophy of service to others. Founder David Green says, "When we serve our employees well, we actually can serve our customers better." For compensation policy, this means the company pays its people as generously as it can in the low-margin world of retailing. As sales have increased, so have the wages paid to employees. Green sees this as a practical way to keep employees and to benefit from their experience: "I would rather have fewer people who have longevity," rather than more minimum-wage workers, because the experienced employees "are more valuable because they know how to answer all the thousands of questions that customers ask."

Hobby Lobby implements the pay policy in a way that is sure to get the attention of its employees. Two Aprils in a row, the company announced that because of its growth, it would increase the hourly wages of store employees. In 2009, the company granted raises to all full-time employees earning less than $13 per hour and set a $10-per-hour minimum for all full-time employees (up from as little as $6.55, which had been the national minimum wage). The initiative benefited more than one-third of the chain's workforce. A year later, the minimum was raised to $11, and the minimum for part-timers was raised to $8. The announcements meant that thousands of employees would get a raise all at the same time.

Store managers announced the changes to gatherings of their employees. Spreading good news in this way generated appreciation and excitement, especially considering that the raises came during years when other companies were instituting layoffs and pay cuts. At the Hobby Lobby store in Athens, Georgia, store manager Tom Lennon said employees' attitudes soared at the news of the first raise: "The associates actually showed more pride than they already did. We're very impressed with the ownership of the company." In Colorado Springs, assistant store manager Adam Garcia witnessed his employees' surprise and gratitude. Although the raise was granted to hourly employees, not managers, the impact was felt at the managerial level, too. Garcia, for example, said of the pay increase, "It gives you confidence—and makes you proud to work for such a good company. It makes you want to work harder."

Sources: Don Nelson, "Art, Craft Company Hikes Pay: Minimum Wage Boost," *Athens (Ga.) Banner-Herald,* April 17, 2010, Business & Company Resource Center, http://galenet.galegroup.com; Katharine Field, "A Matter of Principle," *Chain Store Age,* June 2009, Business & Company Resource Center, http://galenet.galegroup.com; Don Nelson, "Crafts Store Workers Get Good News," *Athens (Ga.) Banner-Herald,* May 3, 2009, Business & Company Resource Center, http://galenet.galegroup.com; and Becky Hurley, "Hobby Lobby Workers Elated about Across-the-Board Pay Hikes," *Colorado Springs Business Journal,* April 17, 2009, Business & Company Resource Center, http://galenet.galegroup.com.

contribute to what employees know and, as a result, what they perceive. If the organization researches salary levels and concludes that it is paying its employees generously, it should communicate this. If the employees do not know what the organization learned from its research, they may reach an entirely different conclusion about their pay. For example, to slow rapid growth in the wages it pays to U.S. workers, Toyota has shifted from using U.S. auto industry wages as its standard. The company now compares its wages with the prevailing wages in the state where each plant is located. Toyota has to educate its employees about this change and convince them that it is a fair way to compare wages.[16]

Employers must also recognize that employees know much more about what other employers pay now than they did before the Internet became popular. In the past, when gathering wage and salary data was expensive and difficult, employers had more leeway in negotiating with individual employees. Today's employees can go to websites like jobstar.org or salary.com to find hundreds of links to wage and salary data. For a fee, executive search firms such as Korn/Ferry provide data. Resources like these give employees information about what other workers are earning, along with the expectation that information will be shared. This means employers will face increased pressure to clearly explain their pay policies.

Managers play the most significant role in communication because they interact with their employees each day (see the "Best Practices" box for a positive example). The HR department should prepare them to explain why the organization's pay structure is designed as it is and to judge whether employee concerns about the structure indicate a need for change. A common issue is whether to reclassify a job because its content has changed. If an employee takes on more responsibility, the employee will often ask the manager for help in seeking more pay for the job.

Job Structure: Relative Value of Jobs

LO5 Explain how organizations design pay structures related to jobs.

Along with market forces and principles of fairness, organizations consider the relative contribution each job should make to the organization's overall performance. In general, an organization's top executives have a great impact on the organization's performance, so they tend to be paid much more than entry-level workers. Executives at the same level of the organization—for example, the vice president of marketing and the vice president of information systems—tend to be paid similar amounts. Creation of a pay structure requires that the organization develop an internal structure showing the relative contribution of its various jobs.

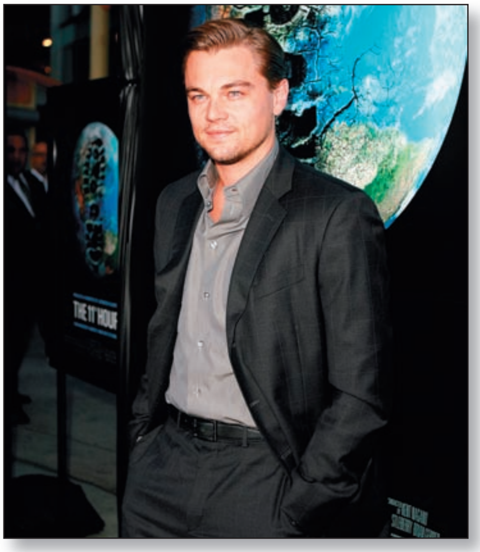
One typical way of doing this is with a **job evaluation,** an administrative procedure for measuring the relative worth of the organization's jobs. Usually, the organization does this by assembling and training a job evaluation committee, consisting of people familiar with the jobs to be evaluated. The committee often includes a human resource specialist and, if its budget permits, may hire an outside consultant.

Job Evaluation
An administrative procedure for measuring the relative internal worth of the organization's jobs.

To conduct a job evaluation, the committee identifies each job's *compensable factors*, meaning the characteristics of a job that the organization values and chooses to pay for. As shown in Table 11.1, an organization might value the experience and education of people performing computer-related jobs, as well as the complexity of those jobs. Other compensable factors might include working conditions and responsibility. Based on the job attributes defined by job analysis (discussed in Chapter 4), the jobs are rated for each factor. The rater assigns each factor a certain number of points, giving more points to factors when they are considered more important and when the job requires a high level of that factor. Often the number of points comes from one of the *point manuals* published by trade groups and management consultants. If necessary, the organization can adapt the scores in the point manual to the organization's situation or even develop its own point manual. As in the example in Table 11.1, the scores for each factor are totaled to arrive at an overall evaluation for each job.

Table 11.1
Job Evaluation of Three Jobs with Three Factors

	COMPENSABLE FACTORS			
JOB TITLE	EXPERIENCE	EDUCATION	COMPLEXITY	TOTAL
Computer operator	40	30	40	110
Computer programmer	40	50	65	155
Systems analyst	65	60	85	210



Popular actors, such as Leonardo DiCaprio, are evaluated by their impact on box office receipts and other revenues and then compensated based on these evaluations.

Job evaluations provide the basis for decisions about relative internal worth. According to the sample assessments in Table 11.1, the job of systems analyst is worth almost twice as much to this organization as the job of computer operator. Therefore, the organization would be willing to pay almost twice as much for the work of a systems analyst as it would for the work of a computer operator.

The organization may limit its pay survey to jobs evaluated as *key jobs*. These are jobs that have relatively stable content and are common among many organizations, so it is possible to obtain survey data about what people earn in these jobs. Organizations can make the process of creating a pay structure more practical by defining key jobs. Research for creating the pay structure is limited to the key jobs that play a significant role in the organization. Pay for the key jobs can be based on survey data, and pay for the organization's other jobs can be based on the organization's job structure. A job with a higher evaluation score than a particular key job would receive higher pay than that key job.

Pay Structure: Putting It All Together

As we described in the first section of this chapter, the pay structure reflects decisions about how much to pay (pay level) and the relative value of each job (job structure). The organization's pay structure should reflect what the organization knows about market forces, as well as its own unique goals and the relative contribution of each job to achieving the goals. By balancing this external and internal information, the organization's goal is to set levels of pay that employees will consider equitable and motivating. Organizations typically apply the information by establishing some combination of pay rates, pay grades, and pay ranges. Within this structure, they may state the pay in terms of a rate per hour, commonly called an **hourly wage;** a rate of pay for each unit produced, known as a **piecework rate;** or a rate of pay per month or year, called a **salary.**

Hourly Wage
Rate of pay for each hour worked.

Piecework Rate
Rate of pay for each unit produced.

Salary
Rate of pay for each week, month, or year worked.

Pay Rates

If the organization's main concern is to match what people are earning in comparable jobs, the organization can base pay directly on market research into as many of its key jobs as possible. To do this, the organization looks for survey data for each job title. If it finds data from more than one survey, it must weight the results based on their quality and relevance. The final number represents what the competition pays. In light of that knowledge, the organization decides what it will pay for the job.

The next step is to determine salaries for the nonkey jobs, for which the organization has no survey data. Instead, the person developing the pay structure creates a graph like the one in Figure 11.4. The vertical axis shows a range of possible pay rates, and the horizontal axis measures the points from the job evaluation. The analyst plots points according to the job evaluation and pay rate for each key job. Finally, the analyst fits a line, called a **pay policy line,** to the points plotted. (This can be done statistically on a computer, using a procedure called regression analysis.)

Pay Policy Line
A graphed line showing the mathematical relationship between job evaluation points and pay rate.

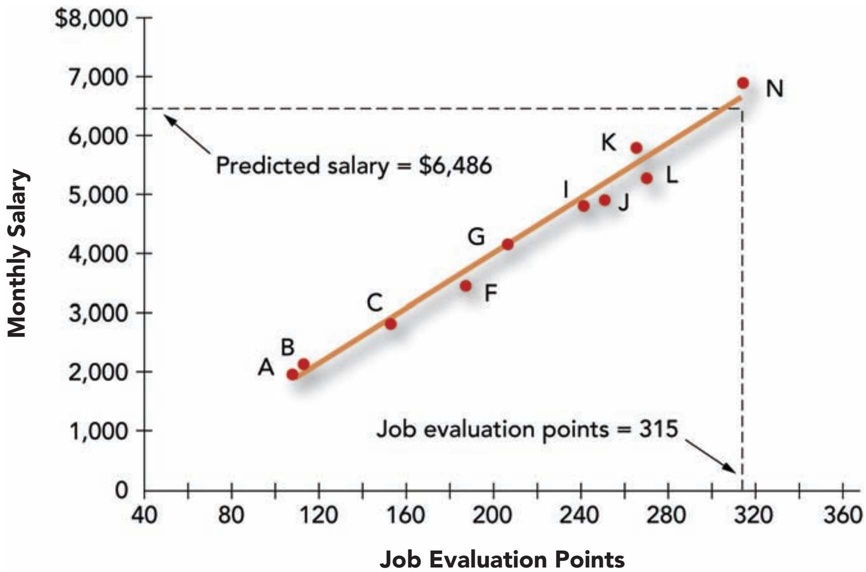


Figure 11.4

Pay Policy Lines

Mathematically, this line shows the relationship between job evaluation and rate of pay. Thus, the line slopes upward from left to right, and if higher-level jobs are especially valuable to the organization, the line may curve upward to indicate even greater pay for high-level jobs. Using this line, the analyst can estimate the market pay level for a given job evaluation. Looking at the graph gives approximate numbers, or the regression analysis will provide an equation for calculating the rate of pay. For example, using the pay policy line in Figure 11.4, a job with 315 evaluation points would have a predicted salary of $6,486 per month.

The pay policy line reflects the pay structure in the market, which does not always match rates in the organization (see key job F in Figure 11.4). Survey data may show that people in certain jobs are actually earning significantly more or less than the amount shown on the pay policy line. For example, some kinds of expertise are in short supply. People with that expertise can command higher salaries, because they can easily leave one employer to get higher pay somewhere else. Suppose, in contrast, that local businesses have laid off many warehouse employees. Because so many of these workers are looking for jobs, organizations may be able to pay them less than the rate that job evaluation points would suggest.

When job structure and market data conflict in these ways, organizations have to decide on a way to resolve the two. One approach is to stick to the job evaluations and pay according to the employees' worth to the organization. Organizations that do so will be paying more or less than they have to, so they will likely have more difficulty competing for customers or employees. A way to moderate this approach is to consider the importance of each position to the organization's goals.[17] If a position is critical for meeting the organization's goals, paying more than competitors pay may be worthwhile.

At the other extreme, the organization could base pay entirely on market forces. However, this approach also has some practical drawbacks. One is that employees may conclude that pay rates are unfair. Two vice presidents or two supervisors will expect to receive similar pay because their responsibilities are similar. If the differences between their pay are large, because of different market rates, the lower-paid employee will likely be dissatisfied. Also, if the organization's development plans include rotating managers through different assignments, the managers will be reluctant to participate if managers in some departments receive lower pay. Organizations therefore must weigh all the objectives of their pay structure to arrive at suitable rates.

Pay Grades

Pay Grades
Sets of jobs having similar worth or content, grouped together to establish rates of pay.

A large organization could have hundreds or even thousands of different jobs. Setting a pay rate for each job would be extremely complex. Therefore, many organizations group jobs into **pay grades**—sets of jobs having similar worth or content, grouped together to establish rates of pay. For example, the organization could establish five pay grades, with the same pay available to employees holding any job within the same grade.

A drawback of pay grades is that grouping jobs will result in rates of pay for individual jobs that do not precisely match the levels specified by the market and the organization's job structure. Suppose, for example, that the organization groups together its senior accountants (with a job evaluation of 255 points) and its senior systems analysts (with a job evaluation of 270 points). Surveys might show that the market rate of pay for systems analysts is higher than that for accountants. In addition, the job evaluations give more points to systems analysts. Even so, for simplicity's sake, the organization pays the same rate for the two jobs because they are in the same pay grade. The organization would have to pay more than the market requires for accountants or pay less than the market rate for systems analysts (so it would probably have difficulty recruiting and retaining them).

Pay Ranges

Pay Range
A set of possible pay rates defined by a minimum, maximum, and midpoint of pay for employees holding a particular job or a job within a particular pay grade.

Usually, organizations want some flexibility in setting pay for individual jobs. They want to be able to pay the most valuable employees the highest amounts and to give rewards for performance, as described in the next chapter. Flexibility also helps the organization balance conflicting information from market surveys and job evaluations. Therefore, pay structure usually includes a **pay range** for each job or pay grade. In other words, the organization establishes a minimum, maximum, and midpoint of pay for employees holding a particular job or a job within a particular pay grade. Employees holding the same job may receive somewhat different pay, depending on where their pay falls within the range.

A typical approach is to use the market rate or the pay policy line as the midpoint of a range for the job or pay grade. The minimum and maximum values for the range may also be based on market surveys of those amounts. Pay ranges are most common for white-collar jobs and for jobs that are not covered by union contracts. Figure 11.5 shows an example of pay ranges based on the pay policy line in Figure 11.4. Notice that the jobs are grouped into five pay grades, each with its own pay range. In this example, the range is widest for employees who are at higher levels in terms of their job evaluation points. That is because the performance of these higher-level employees will likely have more effect on the organization's performance, so the organization needs more latitude to reward them. For instance, as discussed earlier, the organization may want to select a higher point in the range to attract an employee who is more critical to achieving the organization's goals.

Usually pay ranges overlap somewhat, so that the highest pay in one grade is somewhat higher than the lowest pay in the next grade. Overlapping ranges gives the organization more flexibility in transferring employees among jobs, because transfers need not always involve a change in pay. On the other hand, the less overlap, the

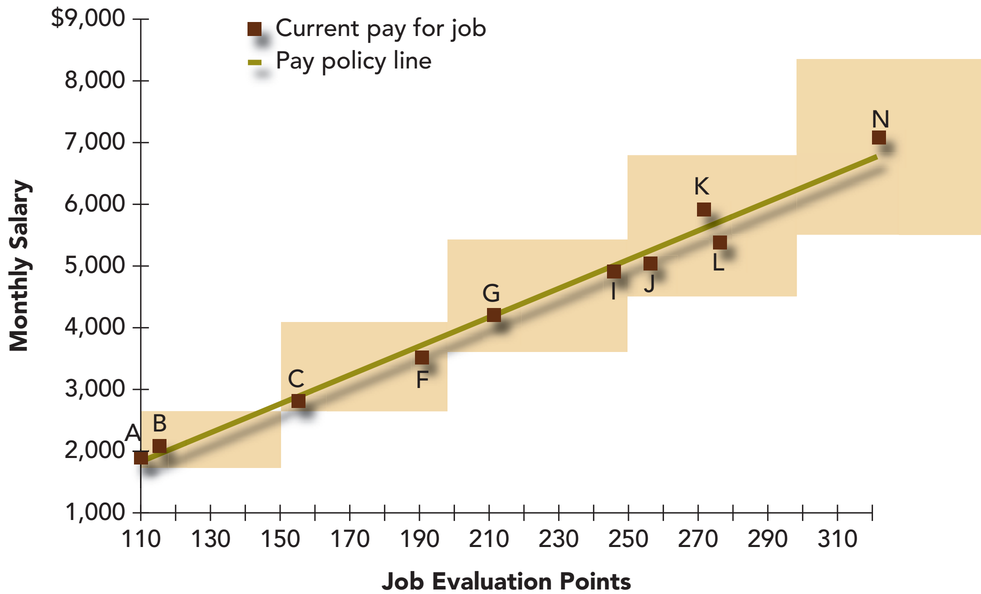


Figure 11.5

Sample Pay Grade Structure

more important it is to earn promotions in order to keep getting raises. Assuming the organization wants to motivate employees through promotions (and assuming enough opportunities for promotion are available), the organization will want to limit the overlap from one level to the next.

Pay Differentials

In some situations organizations adjust pay to reflect differences in working conditions or labor markets. For example, an organization may pay extra to employees who work the night shift, because night hours are less desirable for most workers. Similarly, organizations may pay extra to employees in locations where living expenses are higher. These adjustments are called **pay differentials.**

Pay Differential
Adjustment to a pay rate to reflect differences in working conditions or labor markets.

A survey of businesses in the United States found that almost three-quarters have a policy of providing pay differentials based on geographic location.[18] These differentials are intended as a way to treat employees fairly, without regard to where they work. The most common approach is to move an employee higher in the pay structure to compensate for higher living costs. For instance, the American Chamber of Commerce Research Association estimates that the cost of living in New York City is more than twice that of the average metropolitan area. An organization with employees in New York City and in an average U.S. city might pay its New York office manager substantially more than its office manager in the average city. This pay policy can become expensive for organizations that must operate in high-cost locations. Also, organizations need to handle the delicate issue of how to pay employees transferred to lower-cost areas.

Alternatives to Job-Based Pay

LO6 Describe alternatives to job-based pay.

The traditional and most widely used approach to developing a pay structure focuses on setting pay for jobs or groups of jobs.[19] This emphasis on jobs has some limitations. The precise definition of a job's responsibilities can contribute to an attitude that some activities "are not in my job description," at the expense of flexibility,

Night hours are less desirable for most workers. Therefore, some companies pay a differential for night work to compensate them.

innovation, quality, and customer service. Also, the job structure's focus on higher pay for higher status can work against an effort at empowerment. Organizations may avoid change because it requires repeating the time-consuming process of creating job descriptions and related paperwork. Another change-related problem is that when the organization needs a new set of knowledge, skills, and abilities, the existing pay structure may be rewarding the wrong behaviors. Finally, a pay structure that rewards employees for winning promotions may discourage them from gaining valuable experience through lateral career moves.

Organizations have responded to these problems with a number of alternatives to job-based pay structures. Some organizations have found greater flexibility through **delayering,** or reducing the number of levels in the organization's job structure. By combining more assignments into a single layer, organizations give managers more flexibility in making assignments and awarding pay increases. These broader groupings often are called *broad bands*. In the 1990s, IBM changed from a pay structure with 5,000 job titles and 24 salary grades to one with 1,200 jobs and 10 bands. When IBM began using broad bands, it replaced its point-factor job evaluation system with an approach based on matching jobs to descriptions. Figure 11.6 shows descriptions of several job characteristics used by IBM. Job descriptions are assigned to the band whose characteristics best match those in the job description. Broad bands reduce the opportunities for promoting employees, so organizations that eliminate layers in their job descriptions must find other ways to reward employees.

Delayering
Reducing the number of levels in the organization's job structure.

Another way organizations have responded to the limitations of job-based pay has been to move away from the link to jobs and toward pay structures that reward employees based on their knowledge and skills.[20] **Skill-based pay systems** are pay structures that set pay according to the employees' level of skill or knowledge and what they are capable of doing. Paying for skills makes sense at organizations where changing technology requires employees to continually widen and deepen their knowledge. For example, modern machinery often requires that operators know how to program and monitor computers to perform a variety of tasks. Skill-based pay also supports efforts to empower employees and enrich jobs because it encourages employees to add to their knowledge so they can make decisions in many areas. In this way, skill-based pay helps organizations become more flexible and innovative. More generally, skill-based pay can encourage a climate of learning and adaptability and give employees a broader view of how the organization functions. These changes should help employees use their knowledge and ideas more productively. A field study of a manufacturing plant found that changing to a skill-based pay structure led to better quality and lower labor costs.[21]

Skill-Based Pay Systems
Pay structures that set pay according to the employees' levels of skill or knowledge and what they are capable of doing.

Of course, skill-based pay has its own disadvantages.[22] It rewards employees for acquiring skills but does not provide a way to ensure that employees can use their new skills. The result may be that the organization is paying employees more for learning skills that the employer is not benefiting from. The challenge for HRM is to design work so that the work design and pay structure support one another. Also, if employees learn skills very quickly, they may reach the maximum pay level so quickly that it will become difficult to reward them appropriately. Skill-based pay does not necessarily provide an alternative to the bureaucracy and paperwork of traditional pay structures, because it requires records related to skills, training, and knowledge acquired.

Figure 11.6

IBM's New Job Evaluation Approach

Below is an abbreviated schematic illustration of the new—and simple—IBM job evaluation approach:

POSITION REFERENCE GUIDE

Band	Skills Required	Leadership/Contribution	Scope/Impact
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			

Factors: Leadership/Contribution

Band 06: Understand the mission of the professional group and vision in own area of competence.

Band 07: Understand the departmental mission and vision.

Band 08: Understand departmental/functional mission and vision.

Band 09: Has vision of functional or unit mission.

Band 10: Has vision of overall strategies.

Both the bands and the approach are global. In the U.S., bands 1–5 are nonexempt; bands 6–10 are exempt. Each cell in the table contains descriptive language about key job characteristics. Position descriptions are compared to the chart and assigned to bands on a "best fit" basis. There are no points or scoring mechanisms. Managers assign employees to bands by selecting a position description that most closely resembles the work being done by an employee using an online position description library.

That's it!

SOURCE: From A. S. Richter, "Paying the People in Black at Big Blue," *Compensation and Benefits Review*, May–June 1998, pp. 51–59.

Finally, gathering market data about skill-based pay is difficult, because most wage and salary surveys are job-based.

Pay Structure and Actual Pay

LO7 Summarize how to ensure that pay is actually in line with the pay structure.

Usually, the human resource department is responsible for establishing the organization's pay structure. But building a structure is not the end of the organization's decisions about pay structure. The structure represents the organization's policy, but what the organization actually does may be different. As part of its management responsibility, the HR department therefore should compare actual pay to the pay structure, making sure that policies and practices match.

A common way to do this is to measure a *compa-ratio*, the ratio of average pay to the midpoint of the pay range. Figure 11.7 shows an example. Assuming the organization has pay grades, the organization would find a compa-ratio for each pay grade: the average paid to all employees in the pay grade divided by the midpoint for the pay grade. If the average equals the midpoint, the compa-ratio is 1. More often, the compa-ratio is somewhat above 1 (meaning the average pay is above the midpoint for the pay grade) or below 1 (meaning the average pay is below the midpoint).

Figure 11.7
Finding a Compa-Ratio

Pay Grade: 1
Midpoint of Range: $2,175 per month

Salaries of Employees in Pay Grade	
Employee 1	$2,306
Employee 2	$2,066
Employee 3	$2,523
Employee 4	$2,414

Average Salary of Employees
$2,306 + $2,066 + $2,523 + $2,414 = $9,309
$9,309 ÷ 4 = $2,327.25

Compa-Ratio

$$\frac{\text{Average}}{\text{Midpoint}} = \frac{\$2{,}327.25}{\$2{,}175.00} = 1.07$$

Assuming that the pay structure is well planned to support the organization's goals, the compa-ratios should be close to 1. A compa-ratio greater than 1 suggests that the organization is paying more than planned for human resources and may have difficulty keeping costs under control. A compa-ratio less than 1 suggests that the organization is underpaying for human resources relative to its target and may have difficulty attracting and keeping qualified employees. When compa-ratios are more or less than 1, the numbers signal a need for the HR department to work with managers to identify whether to adjust the pay structure or the organization's pay practices. The compa-ratios may indicate that the pay structure no longer reflects market rates of pay. Or maybe performance appraisals need to be more accurate, as discussed in Chapter 8.

LO8 Discuss issues related to paying employees serving in the military and paying executives.

Current Issues Involving Pay Structure

An organization's policies regarding pay structure greatly influence employees' and even the general public's opinions about the organization. Issues affecting pay structure therefore can hurt or help the organization's reputation and ability to recruit, motivate, and keep employees. Recent issues related to pay structure include decisions about paying employees on active military duty and decisions about how much to pay the organization's top executives.

Pay during Military Duty

focus on **social responsibility**

As we noted in Chapter 3, the Uniformed Services Employment and Reemployment Rights Act (USERRA) requires employers to make jobs available to their workers when they return after fulfilling military duties for up to five years. During the time these employees are performing their military service, the employer faces decisions related to paying these people. The armed services pay service members during their time of duty, but military pay often falls short of what they would earn in their civilian jobs. Some employers have chosen to support their employees by paying the difference between their military and civilian earnings for extended periods. First Data, which processes payments made with credit and debit cards, provides this type of differential pay to its employees during military deployment. The company also continues medical and life insurance benefits to employees serving in the military and their families. Besides providing this compensation-related support, First Data encourages its employees to support the troops with care packages and volunteer services at veterans' hospitals.[23]

Policies to make up the difference between military pay and civilian pay are costly. The employer is paying employees while they are not working for the organization, and it may have to hire temporary employees as well. This challenge has posed a significant hardship on some employers since 2002, as hundreds of thousands of Reservists and National Guard members have been mobilized. Even so, as the nation copes with this challenge, hundreds of employers have decided that maintaining positive relations with employees—and the goodwill of the American public—makes the expense worthwhile.

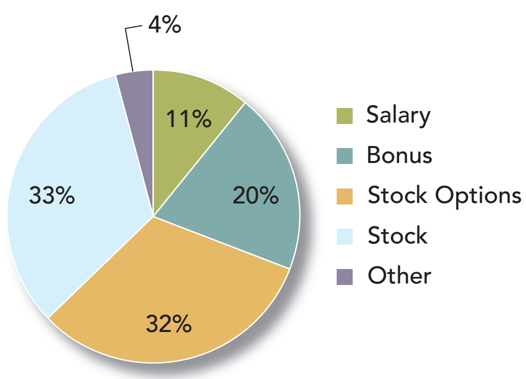
Pay for Executives

The media have drawn public attention to the issue of executive pay. The issue attracts notice because of the very high pay that the top executives of major U.S. companies have received in recent years. In recent years, the total compensation paid to executives of large companies was typically more than $6 million, of which about $2.5 million was in the form of salary plus bonus. Interestingly, at the five companies that had the highest shareholder returns in 2006, the median compensation was less than $5 million, and at the five companies with the lowest shareholder returns, CEOs earned more than $12 million.[24] Notice, however, that as shown in Figure 11.8, only a small share of the average compensation paid to CEOs is in the form of a salary. Most CEO compensation takes the form of performance-related pay, such as bonuses and stock; this variable pay is discussed in the next chapter.

Although these high amounts apply to only a small proportion of the total workforce, the issue of executive pay is relevant to pay structure in terms of equity theory. As we discussed earlier in the chapter, employees draw conclusions about the fairness of pay by making comparisons among employees' inputs and outcomes. By many comparisons, U.S. CEOs' pay is high. For example, when CEO pay is compared with the pay of the organization's lowest-level employees, the resulting ratio has been on the rise for more than two decades, surpassing 500:1 at large U.S. corporations in 2007. That ratio is greater in the United States than in other developed nations and was higher in 2007 than in any period measured before then.[25] To assess the fairness of this ratio, equity theory would consider not only the size of executive pay relative to pay for other employees but also the amount the CEOs contribute. An organization's executives potentially have a much greater effect on the organization's performance than its lowest-paid employees have. But if they do not seem to contribute 500 times

Figure 11.8

Average CEO Pay in S&P 500 Companies



SOURCE: Data for fiscal year 2008 from Edward E. Lawler III, "Fixing Executive Compensation: Right Time, Wrong Approach," *Chief Executive*, May/June 2009, pp. 30–41.

more, employees will see the compensation as unfair. Likewise, if CEOs in the United States don't contribute more to their organization than CEOs in other countries do, the difference would be perceived as unfair.

focus on **social responsibility**

Top executives help to set the tone or culture of the organization, and employees at all levels are affected by behavior at the top. As a result, the equity of executive pay can affect more employees than, say, equity among warehouse workers or sales clerks. Recognizing the impact of his pay on his employees (and investors), John Mackey, founder and CEO of Whole Foods, reacted to poor financial results in 2007 by cutting his salary to $1 and taking no bonus or stock options. He donated his remaining compensation (from a previous bonus plan) to a charity, the Global Animal Partnership. Mackey has blamed the big pay gap between executives and employees on poor performance by demoralized workers.[26]

One study that investigated this issue compared the pay of rank-and-file employees and executives in various business units.[27] In business units where the difference in pay was greater, customer satisfaction was lower. The researchers speculated that employees thought pay was inequitable and adjusted their behavior to provide lower inputs by putting forth less effort to satisfy customers. To avoid this type of situation, organizations need to plan not only *how much* to pay managers and executives, but also *how* to pay them. In the next chapter, we will explore many of the options available.

thinking ethically

CAN THE BURDEN OF CUTBACKS BE SHARED EQUITABLY?

The downturn in the construction industry took a heavy toll on Aquapoint, a company based in New Bedford, Massachusetts, that makes systems for wastewater treatment. As builders delayed construction of new housing developments, revenues began to slow. When a big account, a retirement community, lost bank financing, Aquapoint's management knew the company wouldn't have enough cash to pay its bills.

Some companies might start with layoffs or pay cuts for employees, but Aquapoint's leaders thought they should share the pain. The top three executives cut their pay by half. Then they asked employees to accept a 10 percent pay cut. The next months were a struggle, but management thought the company would prosper as soon as the economy began to improve. They didn't want to lose valuable employees just before the next surge in business. For a few months, the executives cut their pay again, down to zero. As the company passed the worst point, two of the executives began to work for 25 percent of their pay, and the executives hope they can eventually make up for the lost salaries with a bonus.

Questions

1. In your opinion, how fair was this approach to cutting pay when times got difficult at Aquapoint? Explain your reasoning.
2. As business improves, what approach should the company follow to restore the pay of the executives and the employees? Why?
3. How can Aquapoint ensure that its employees appreciate the leaders' willingness to share the pain of the recent economic downturn? Why is it important for employees to witness management's commitment to ethical conduct?

SOURCE: Based on Riva Richmond, "How to Cut Payroll Costs without Layoffs," *BusinessWeek*, April 3, 2009.

SUMMARY

LO1 Identify the kinds of decisions involved in establishing a pay structure.

Organizations make decisions to define a job structure, or relative pay for different jobs within the organization. They establish relative pay for different functions and different levels of responsibility for each function. Organizations also must establish pay levels, or the average paid for the different jobs. These decisions are based on the organization's goals, market data, legal requirements, and principles of fairness. Together, job structure and pay level establish a pay structure policy.

LO2 Summarize legal requirements for pay policies.

To meet the standard of equal employment opportunity, employers must provide equal pay for equal work, regardless of an employee's age, race, sex, or other protected status. Differences in pay must relate to factors such as a person's qualifications or market levels of pay. Under the Fair Labor Standards Act (FLSA), the employer must pay at least the minimum wage established by law. Some state and local governments have established higher minimum wages. The FLSA also requires overtime pay—at one and a half times the employee's regular pay rate, including bonuses—for hours worked beyond 40 in each week. Managers, professionals, and outside salespersons are exempt from the overtime pay requirement. Employers must meet FLSA requirements concerning child labor. Federal contractors also must meet requirements to pay at least the prevailing wage in the area where their employees work.

LO3 Discuss how economic forces influence decisions about pay.

To remain competitive, employers must meet the demands of product and labor markets. Product markets seek to buy at the lowest price, so organizations must limit their costs as much as possible. In this way, product markets place an upper limit on the pay an employer can afford to offer. Labor markets consist of workers who want to earn as much as possible. To attract and keep workers, employers must pay at least the going rate in their labor markets. Organizations make decisions about whether to pay at, above, or below the pay rate set by these market forces. Paying above the market rate may make the organization less competitive in product markets but give it an advantage in labor markets. The organization benefits only if it can attract the best candidates and provide the systems that motivate and enable them to do their best work. Organizations that pay below the market rate need creative practices for recruiting and training workers so that they can find and keep enough qualified people.

LO4 Describe how employees evaluate the fairness of a pay structure.

According to equity theory, employees think of their pay relative to their inputs, such as training, experience, and effort. To decide whether their pay is equitable, they compare their outcome (pay)/input ratio with other people's outcome/input ratios. Employees make these comparisons with people doing the same job in other organizations and with people doing the same or different jobs in the same organization. If employees conclude that their outcome/input ratio is less than the comparison person's, they conclude that their pay is unfair and may engage in behaviors to create a situation they think is fair.

LO5 Explain how organizations design pay structures related to jobs.

Organizations typically begin with a job evaluation to measure the relative worth of their jobs. A job evaluation committee identifies each job's compensable factors and rates each factor. The committee may use a point manual to assign an appropriate number of points to each job. The committee can research market pay levels for key jobs, then identify appropriate rates of pay for other jobs, based on their number of points relative to the key jobs. The organization can do this with a pay policy line, which plots a salary for each job. The organization can combine jobs into several groups, called pay grades. For each pay grade or job, the organization typically establishes a pay range, using the market rate or pay policy line as the midpoint. Differences in working conditions or labor markets sometimes call for the use of pay differentials to adjust pay levels.

LO6 Describe alternatives to job-based pay.

To obtain more flexibility, organizations may reduce the levels in the organization's job structure. This process of delayering creates broad bands of jobs with a pay range for each. Other organizations reward employees according to their knowledge and skills. They establish skill-based pay systems, or structures that set pay according to the employees' level of knowledge and what they are capable of doing. This encourages employees to be more flexible and adapt to changing technology. However, if the organization does not also provide systems in which employees can apply new skills, it may be paying them for skills they do not actually use.

LO7 Summarize how to ensure that pay is actually in line with the pay structure.

The human resource department should routinely compare actual pay with the pay structure to see that policies and practices match. A common way to do this is to measure a compa-ratio for each job or pay grade. The compa-ratio is the ratio of average pay to the midpoint of the pay range. Assuming the pay structure supports the organization's goals, the compa-ratios should be close to 1. When compa-ratios are more or less than 1, the HR department should work with managers to identify whether to adjust the pay structure or the organization's pay practices.

LO8 Discuss issues related to paying employees serving in the military and paying executives.

The Uniformed Services Employment and Reemployment Rights Act requires employers to make jobs available to any of their employees who leave to fulfill military duties for up to five years. While these employees are performing their military service, many are earning far less. To demonstrate their commitment to these employees and to earn the public's goodwill, many companies pay the difference between their military and civilian earnings, even though this policy is costly. Executive pay has drawn public scrutiny because top executive pay is much higher than average workers' pay. The great difference is an issue in terms of equity theory. Chief executive officers have an extremely large impact on the organization's performance, but critics complain that when performance falters, executive pay does not decline as fast as the organization's profits or stock price. Top executives help to set the organization's tone or culture, and employees at all levels are affected by the behavior of the people at the top. Therefore, employees' opinions about the equity of executive pay can have a large effect on the organization's performance.

KEY TERMS

benchmarking, p. 335
delayering, p. 344
exempt employees, p. 331
Fair Labor Standards Act (FLSA), p. 330
hourly wage, p. 340
job evaluation, p. 339
job structure, p. 327
minimum wage, p. 330
nonexempt employees, p. 331
pay differential, p. 343
pay grades, p. 342
pay level, p. 327
pay policy line, p. 340
pay range, p. 342
pay structure, p. 327
piecework rate, p. 340
salary, p. 340
skill-based pay systems, p. 344

REVIEW AND DISCUSSION QUESTIONS

1. In setting up a pay structure, what legal requirements must an organization meet? Which of these do you think would be most challenging for a small start-up business? Why?
2. In gathering data for its pay policies, what product markets would a city's hospital want to use as a basis for comparison? What labor markets would be relevant? How might the labor markets for surgeons be different from the labor markets for nursing aides?
3. Why might an organization choose to pay employees more than the market rate? Why might it choose to pay less? What are the consequences of paying more or less than the market rate?
4. Suppose you work in the HR department of a manufacturing company that is planning to enrich jobs by having production workers work in teams and rotate through various jobs. The pay structure will have to be adjusted to fit this new work design. How would you expect the employees to evaluate the fairness of their pay in their redesigned jobs? In terms of equity theory, what comparisons would they be likely to make?
5. Summarize the way organizations use information about jobs as a basis for a pay structure.
6. Imagine that you manage human resources for a small business. You have recently prepared a report on the market rate of pay for salespeople, and the company's owner says the market rate is too high. The company cannot afford this level of pay, and furthermore, paying that much would cause salespeople to earn more than most of the company's managers. Suggest three possible measures the company might take to help resolve this conflict.
7. What are the advantages of establishing pay ranges, rather than specific pay levels, for each job? What are the drawbacks of this approach?
8. Suppose the company in Question 1 wants to establish a skills-based pay structure. What would be some advantages of this approach? List the issues the company should be prepared to address in setting up this system. Consider the kinds of information you will need and the ways employees may react to the new pay structure.

9. Why do some employers subsidize the pay of military reserve members called up to active duty? If the military instead paid these people the wage they command in the civilian market (that is, the salary they earn at their regular jobs), who would bear the cost? When neither the reserve members' employers nor the military pays reserve members their civilian wage, reserve members and their families bear the cost. In your opinion, who *should* bear this cost—employers, taxpayers, or service members (or someone else)?
10. Do you think U.S. companies pay their chief executives too much? Why or why not?

BUSINESSWEEK CASE

BusinessWeek Law Firms Slash First-Year Pay

Law firms including Cravath, Swaine & Moore LLP and Skadden, Arps, Slate, Meagher & Flom LLP cut year-end bonuses for first-year lawyers by as much as 71 percent, part of a plan to keep client costs down and ride out a recession that has forced structural changes in the industry. Bonuses dropped for first-year associates at many top-tier New York firms while staying the same or increasing for more experienced associates. Bonus reductions, along with overall pay cuts, signal a diminished role for junior lawyers at the larger U.S. firms, said consultant Bruce MacEwen.

The industrywide move to cut pay is "reflecting, frankly, the low value clients place on junior associates," MacEwen, who is based in New York, said in a phone interview.

Facing a slowdown in work due to the financial crisis, law firms fired thousands of associates this year and last, forced new hires to delay starting dates and cut hours in exchange for reduced salaries. Demand for legal services dropped 6.8 percent in the first nine months of 2009 compared with [2008], according to Citi Private Bank.

New York firms including Cleary Gottlieb Steen & Hamilton LLP, Sullivan & Cromwell LLP, Cravath, and Skadden Arps cut seniority-based bonuses from $17,500 to $5,000 for first-year associates. Other firms, such as San Francisco–based Morrison & Foerster LLP, Reed Smith LLP in Pittsburgh, and DLA Piper LLP in Chicago, cut starting salaries for first-year associates from $160,000 to as low as $130,000 this year. Firms in cities including New York, Washington, and San Francisco had adopted $160,000 as the industry standard beginning in January 2007.

Cleary's managing partner, Mark Walker, said the cuts aren't a reflection on the value of young associates at his firm. The best are traditionally offered partnerships after spending eight years as salaried associates. "The young lawyers today are the senior lawyers five years from now," Walker said.

Jeffrey Grossman, of the Legal Specialty Group at Well Fargo & Co., said U.S. law firms are cutting associate pay to temper their decline in profitability. Even partners are taking home less, he said.

Today's economic justification, however, may reap rewards for law firm bottom lines tomorrow when revenue increases. "It will be a future benefit," said Grossman. "It will change the cost structure for future years."

An additional consideration in paring pay, the law firm consultants said, is the need to address increased pushback from corporate clients seeking reduced hourly billing rates. Rates for the least experienced attorneys typically range from $250 to $350 an hour, MacEwen said, spurring some clients to complain they are paying top dollar for the training of young lawyers. The perception has existed for years and "bubbled to the surface" during the recession, Grossman said.

The bigger firms—which often move as a bloc in setting pay—still recognize they need to nurture top young lawyers. As a result, Grossman said, some have reconfigured compensation to reward high performance.

Orrick, Herrington & Sutcliffe LLP, based in San Francisco, this month said it would eliminate bonuses for first-year associates, while keeping salaries the same. It instituted a new system in which they get raises based on performance rather than seniority. The changes were made to align pay with performance and client needs, said Orrick CEO Ralph Baxter.

SOURCE: Excerpted from Carlyn Kolker, "Law Firms Slash First-Year Pay," *BusinessWeek*, December 21, 2009, www.businessweek.com.

Questions

1. Based on the information given, what issues have law firms considered in their decisions about their pay structure? (See Figure 11.1 for a summary of issues.)
2. Use the Bureau of Labor Statistics wage query system (at www.bls.gov) to look up information about compensation paid to lawyers. Compare the data you gathered with the information about compensation given in this case.
3. How would you expect first-year lawyers to perceive the fairness of the pay decisions described in this case? How could the decisions be communicated so that lawyers in these firms will see their pay as fair?

Case: How Fog Creek Software Pays Developers

When Joel Spolsky and Michael Pryor founded Fog Creek Software, their vision was of a company run by people whose technical backgrounds meant they understood what really motivates programmers. The company would hire the best, make them comfortable, pay them well, and then get out of the way so they could create great products.

Early on, Spolsky and Pryor set out to develop a pay structure that would be consistent with the company's mission. They decided that the system should be so objective that there would be no questioning or judgment calls about which employee earns how much. And the results would be so objective and fair that there would be no incentive to be secretive about what any employee earns.

Like any computer pro, Spolsky went online for ideas. He discovered that Construx, a software consulting firm, had posted online an outline for measuring levels of the software profession. Using this as a starting point, Spolsky created a job structure for Fog Creek. The structure is straightforward: every employee is assigned to a level between 8 (summer interns) and 16 (chief executive officer). Assignment to a level is not a judgment call but is based on a formula incorporating the employee's experience, skills, and scope of responsibility.

- Experience is measured as the number of years of full-time experience in the field of the employee's job at Fog Creek, counting only years after the employee finished school. At any given level, every employee earns the same salary.
- Skills are defined with descriptive statements along a continuum. For example, at the lowest level is a programmer "learning the basic principles of software engineering" who needs close supervision. At the other extreme would be someone who makes a unique contribution—a programmer who "has consistently had major success during participation in all aspects of small and large projects."
- Scope of responsibility ranges from primarily supporting another employee to running multiple projects.

Based on this job structure, Spolsky created a chart that is used for assigning each employee to a level.

Spolsky also created a chart that indicates the base salary for each level, based on market salaries obtained from sources such as Salary.com and Glassdoor.com. Each employee earns the amount specified by the chart. Every year, the company's managers review each employee's work to see if the employee should be assigned to a new level. Every employee who is reassigned then earns the amount associated with the new level. Employees also earn a bonus based on the company's profits for the year.

Fog Creek's system has been challenged by the stiff competition for programmer talent. If the company paid extra to lure in new employees at a higher rate, the existing employees would demand a raise or see their treatment as unfair. Rather than expect employees to accept the "salary inversion" of newer employees earning more than their more-experienced colleagues, Fog Creek has responded to talent crunches by raising the salaries of all employees at a given level to make them as high as the going market rate for that level. Spolsky believes that this solution is expensive but essential for maintaining equity and keeping talent.

SOURCES: Joel Spolsky, "Why I Never Let Employees Negotiate a Raise," *Inc.*, April 2009, www.inc.com; and Fog Creek Software, "Careers" and "About the Company," corporate Web site, www.fogcreek.com, accessed April 21, 2010.

Questions

1. How well does Fog Creek Software's pay structure meet (a) the legal requirement of equal pay for equal work; (b) the conditions of product markets; and (c) the conditions of labor markets?
2. Joel Spolsky set out to create a pay structure that is objective. Based on the information given, how objective would you say Fog Creek's system is? What other qualities besides objectivity do you think Fog Creek's employees might care about?
3. Fog Creek is a small company with a few dozen technical employees. How might its pay structure need to change (if at all) if the company grows to hundreds of employees? Would these changes likely appeal to the employees?

IT'S A WRAP!

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Review
- Chapter learning objectives

Application
- Manager's Hot Seat segment: "Negotiation: Thawing the Salary Freeze"
- Video case and quiz: "Gender Gap: Why Do Women Make Less than Men?"
- Self-Assessment: Test your expectation of salary brackets
- Web Exercise: Experiment with salary calculators
- Small-business case: Changing the Pay Level at Eight Crossings

Practice
- Chapter quiz

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