Compensation Strategies and Practices

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

- Identify the two general types of compensation and the components of each.

- Give examples of two different compensation philosophies in organizations.

- Discuss four strategic compensation design issues currently being used.

- Describe three behavioral considerations affecting compensation activities.

- Identify the basic provisions of the Fair Labor Standards Act (FLSA).

- Define *job evaluation* and discuss four methods of performing it.

- Outline the process of building a wage and salary administration system.

- Discuss how a pay-for-performance system is established.

HR TRANSITIONS

Strategic Redesign of Compensation at Bayer

The important link between a firm's strategic objectives and its compensation system is illustrated by what has occurred at Bayer Corporation. The process used and experiences at Bayer also illustrate how compensation systems must be compatible with the culture of an organization.

Bayer Corporation is a subsidiary of Bayer Group AG, a Germany-based global chemical company. Several years ago, Bayer Corporation was created by combining three different operating companies, each with its own markets, products, and cultures—Mobay Chemicals, Miles, Inc., and Agfa. Bayer executives recognized that compensation systems were a critical component of creating a corporate culture that embodies the values and visions developed during the strategic planning for the new firm. Once the merger of the three entities had occurred, a new organizational structure was implemented. This structure had fewer layers and levels, and was developed to give Bayer employees the flexibility to move across organizational units and internationally.

Bayer, like many organizations today, compensated people for doing specific jobs. But they wanted to reward people for their flexibility in playing different roles in the organization and moving between jobs. At the same time, Bayer executives wanted a simple compensation system that was tied to the core values and culture that Bayer hoped would evolve.

Bayer began its transition to a different compensation system by establishing a task force of 14 executives chaired by Bayer's Vice-President of Benefits. This Job Advisory Committee, as it was labeled, was to recommend the processes needed to move to a job evaluation system more aligned with the new organization. Job evaluation, the systematic process of determining the internal value of jobs in relation to other jobs, had previously been done in two of the companies using a traditional point factor system; however the third entity had not used a formal job evaluation system.

The committee began by identifying the advantages and disadvantages of the existing point system. The committee identified many features of the old system that were working well, particularly the involvement of managers and employees in the job evaluation "pointing" process. But the committee felt that the existing point factors and dimensions were too task-based, and they did not reflect the flexibility desired as part of the organizational culture. Also, greater recognition of employees' capabilities, not just their jobs and budgetary responsibilities, needed to be considered.

Assisted by a major consulting firm over a period of time and a number of meetings, the committee decided to redesign the job evaluation system and focus on work-value competencies.

The new work-value clusters defined were:

- Improvement opportunity
- Contribution
- Capability
- Expertise and complexity
- Leadership and integration
- Relationship-building skills

For these six clusters, the committee identified scales and point values. The process of developing the new factors and points took about a year.

Once the new system had been tested by pointing jobs on both the old and new systems, fine-tuning was needed. Ultimately, a cross-section of benchmark jobs was pointed using the new system and the results calibrated statistically to the old system, rather than having all jobs in the organization repointed again.

The ultimate test of the new job evaluation system has been its acceptance and use throughout Bayer. Based on feedback from managers and employees alike, the new system is working well. Bayer's job evaluation system has become the means of aligning its compensation system with the business values of the new corporate culture being created. The compensation plan also supports business strategies and rewards employees as Bayer grows and meets its strategic objectives.[1]

Greater recognition of employees' capabilities, not just their jobs and budgetary responsibilities, needed to be considered.

> 66 *Organizations need to be fluid to move as markets move. That necessitates a more flexible approach to compensation.* 99
>
> KATHRYN McKEE, SPHR, CCP

Compensation systems in organizations must be linked to organizational objectives and strategies, as the opening discussion of Bayer Corporation indicates. But compensation also requires balancing the interests and costs of the employer with the expectations of employees.[2] A compensation program in an organization should have four objectives:

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

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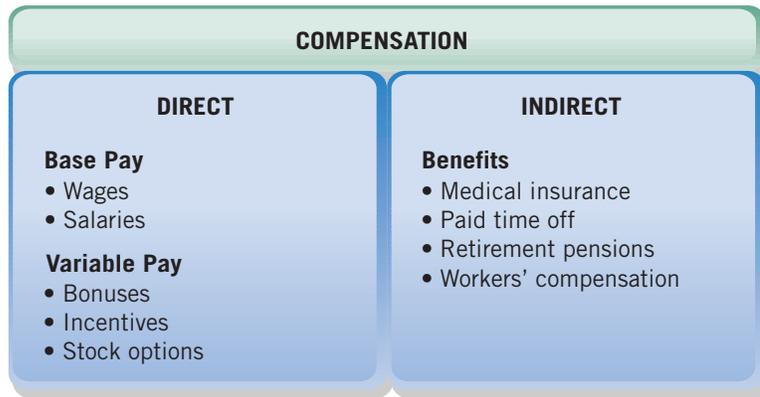
Nature of Compensation

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

Types of Compensation

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

BASE PAY The basic compensation that an employee receives, usually as a wage or salary, is called **base pay.** Many organizations use two base pay categories, *hourly* and *salaried,* which are identified according to the way pay is distributed and the nature of the jobs. Hourly pay is the most common means of payment based on time; employees who are paid hourly are said to receive **wages**, which are payments directly calculated on the amount of time worked. In contrast, people who are paid **salaries** receive payments that are consistent from period to period despite the number of hours worked. Being salaried typically has carried higher status for employees than being paid wages. Some organizations have

Base pay

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

Wages

Payments directly calculated on the amount of time worked.

Salaries

Payments that are consistent from period to period despite the number of hours worked.

FIGURE 13–1 *Components of a Compensation Program*

COMPENSATION	
DIRECT	**INDIRECT**
Base Pay • Wages • Salaries **Variable Pay** • Bonuses • Incentives • Stock options	**Benefits** • Medical insurance • Paid time off • Retirement pensions • Workers' compensation

switched to an all-salaried approach with their manufacturing and clerical employees in order to create a greater sense of loyalty and organizational commitment. But they still must pay overtime to certain employees in jobs covered by federal and state pay laws.

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

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

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

Benefit
An indirect reward given to an employee or group of employees as a part of organizational membership.

Compensation Responsibilities

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

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

FIGURE 13–2 *Typical Compensation Responsibilities*

HR Unit	Managers
● Develops and administers compensation system ● Conducts job evaluation and wage surveys ● Develops wage/salary structures and policies	● Attempt to match performance and rewards ● Recommend pay rates and increases based on guidelines from HR unit ● Evaluate employee performance for compensation purposes

that performance when deciding compensation increases within the policies and guidelines established by the HR unit.

Strategic Compensation

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

Compensation Philosophies

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

ENTITLEMENT ORIENTATION The entitlement philosophy can be seen in many organizations that traditionally have given automatic increases to their employees every year. Further, most of those employees receive the same or nearly the same percentage increase each year. Employees and managers who subscribe to the entitlement philosophy believe that individuals who have worked another year are *entitled* to a raise in base pay, and that all incentives and benefit programs should continue and be increased, regardless of changing industry or economic conditions. Commonly, in organizations following an entitlement philosophy, pay increases are referred to as *cost-of-living* raises, whether or not they are tied specifically to economic indicators. Following an entitlement

FIGURE 13–3 *Continuum of Compensation Philosophies*

◀ • • • • •   **Entitlement** • **Performance** • • • • • • • • • • ▶

- Seniority-based
- Across-the-board raises
- "Guaranteed" movement of scales
- Industry comparisons only
- "Santa Claus" bonuses

- No raises for length of service
- No raises for longer-service poor performers
- Market adjusted pay structures
- Broader industry comparison
- Bonuses tied to performance results

philosophy ultimately means that as employees continue their employment lives, employer costs increase, regardless of employee performance or other organizational competitive pressures. Market comparisons tend to be made within an industry, rather than more broadly considering compensation in firms of all types. Bonuses in many entitlement-oriented organizations are determined very paternalistically and often do not reflect operating results. Instead, the CEO or owner acts as Santa Claus at the end of the year, passing out bonus checks that generally do not vary from year to year. Therefore employees "expect" to receive the bonuses as another form of entitlement.

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

Bonuses are paid based on individual, group, and/or organizational performance results. Few organizations are totally performance-oriented in all facets of their compensation practices. However, breaking the entitlement mode is increasingly occurring in the organizational restructuring common throughout many industries. A study of public-sector HR managers found that there is a desire and need to shift toward more performance-oriented compensation practices in many public-sector organizations.[3] How fast that occurs, given the historical traditions and the strength of public-sector unions, remains to be seen.

Strategic Compensation Design

Designing a compensation system for an organization requires knowledge of the strategic issues facing the organization and the culture of the organization. Organizations today are facing more pressures and greater demands for flexibility from their managers and employees. As Figure 13–4 on the next page notes, compensation strategies used in organizations have shifted. Organizations that are more static have fixed salaries, limited participation in bonuses, and other features clearly focused internally. However, dynamic, rapidly changing organizations have more varied compensation systems that reward current performance and growth.

FIGURE 13–4 *Changing Compensation Strategies*

Yesterday	Today	Tomorrow
● Fixed salary	● Variable pay as add-on to salary	● Low fixed salary, more variable pay
● Bonuses/perks for executives only	● Variable pay emerging throughout organization	● Variable pay common throughout the organization
● Fixed benefits, reward long tenure	● Flexible benefits	● Portable benefits
● Company-based career, "moving up"	● Industry-based career, "moving around"	● Skill-based career, interim employment
● Hierarchical organizations	● Flatter, team-based organizations	● Networked "virtual" organizations
● "Cookie cutter" pay plans	● Total compensation (Look at benefits, too)	● Customized, integrated pay systems; pay, benefits, intangibles

SOURCE: Reprinted from September 1996 *ACA News,* with permission from the American Compensation Association (ACA), 14040 N. Northsight Blvd., Scottsdale, Arizona 85260; telephone 602/951-9191; fax 602/483-8352. © ACA. http://www.acaonline.org

COMPENSATION AND ORGANIZATIONAL CULTURE It is critical that organizations align their compensation practices with their organizational cultures, especially if efforts are made to change the cultures because of competitive pressures. For instance, a telecommunications firm faced major changes in the industry after government restrictions on pricing were removed and cable television firms were allowed to provide telephone service. The firm could not continue to offer the wages it had paid when government agencies allowed the pricing of services to obtain full cost recovery and a set level of profits. When changing organizational culture, organizations must change their compensation systems if they are to avoid sending mixed signals to employees. The opening discussion about Bayer Corporation illustrates the importance of matching compensation practices to the organizational culture.

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

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

Most employers position themselves in the *second quartile,* in the middle of the market, based on pay survey data of other employers' compensation plans.

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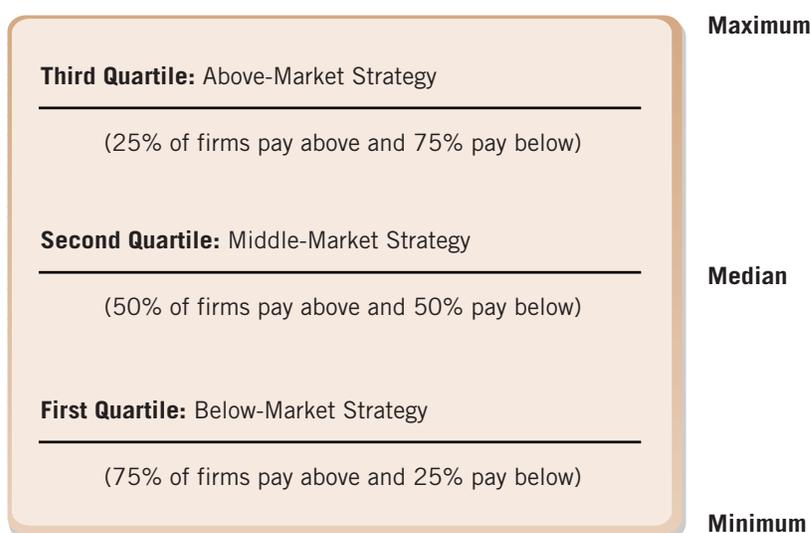
An employer using a *first-quartile* approach is choosing to pay below market compensation. This may be done for several reasons. One is because of a shortage of funds and the inability to pay more and still meet strategic objectives. Also, if there is an abundance of workers, particularly those with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

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

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

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

FIGURE 13–5 *Compensation Quartile Strategies*

	Maximum
Third Quartile: Above-Market Strategy	
(25% of firms pay above and 75% pay below)	
Second Quartile: Middle-Market Strategy	Median
(50% of firms pay above and 50% pay below)	
First Quartile: Below-Market Strategy	
(75% of firms pay above and 25% pay below)	Minimum

HR PERSPECTIVE

Research on Skill-Based Pay and Organization Performance

A growing number of organizations have adopted competency-based pay programs that focus on employee skills. But whether these skill-based pay programs result in organizational performance and productivity increases has not been documented. Murray and Gebhart conducted a study, published in the *Academy of Management Journal,* that focused on providing data on this issue.

The researchers gathered data from an organization that had adopted a skill-based pay (SBP) plan and a comparable organization that was using a traditional task-based plan. Both organizations were component assembly plants of the same large manufacturing corporation.

First, the researchers interviewed managers at the plant using the SBP plan and obtained details on the plan. In the SBP plan five skill blocks had been identified, and employees progressed through them as they acquired more capabilities. Employees were offered training on the skills, and they had to demonstrate skill mastery both initially and ongoing.

Next, data was gathered from both plants to track labor costs per part, productivity, and quality. Using statistical analyses, the researchers found that the plant using SBP had 58% greater productivity, 82% better scrap reduction, and 16% lower cost per part produced than in the comparable facility not using SBP. Based on these results, the researchers suggested that the positive effects found in the plant using an SBP plan are due to the comprehensive HR efforts needed to make the SBP plan work.[4]

skill-based pay (SBP) systems, employees start at a base level of pay and receive increases as they learn to do other jobs or gain other skills and therefore become more valuable to the employer. For example, a printing firm has two-color, four-color, and six-color presses. The more colors, the more skill required of the press operators. Under a KBP or SBP system, press operators increase their pay as they learn how to operate the more complex presses, even though sometimes they may be running only two-color jobs. The HR Perspective describes research on such a plan.

A survey sponsored by the American Compensation Association (ACA) found that the success of competency plans requires managerial commitment to a philosophy different from the one that has existed traditionally in organizations.[5] This approach places far more emphasis on training employees and supervisors. Also, workflow must be adapted to allow workers to move from job to job as needed.

When an organization moves to a competency-based system, considerable time must be spent identifying what the required competencies are for various jobs.[6] Then each *block* of competencies must be priced using market data. Progression of employees must be possible, and they must be paid appropriately for all of their competencies. Any *limitations* on the numbers of people who can acquire more competencies should be clearly identified. *Training* in the appropriate competencies is particularly critical. Also important to a competency-based system is a means for *certification* of employees who have acquired certain competencies. Further, a process must exist for verifying that employees *maintain competencies.* In summary, use of a competency-based system requires significant investment of management time and needs a continuous commitment by top management.

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

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

Employee-Related Outcomes
- Enhanced employee understanding of organizational "big picture"
- Greater employee self-management capabilities
- Improved employee satisfaction
- Greater employee commitment

Because competency plans focus on growth and development of employee competencies, those employees who continue to develop their competencies to receive pay raises are the real winners. As more organizations recognize the value of human resources, it is likely that competency-based systems may spread.

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

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

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

FIGURE 13–6 *Traditional Pay Structure vs. Broadbanding*
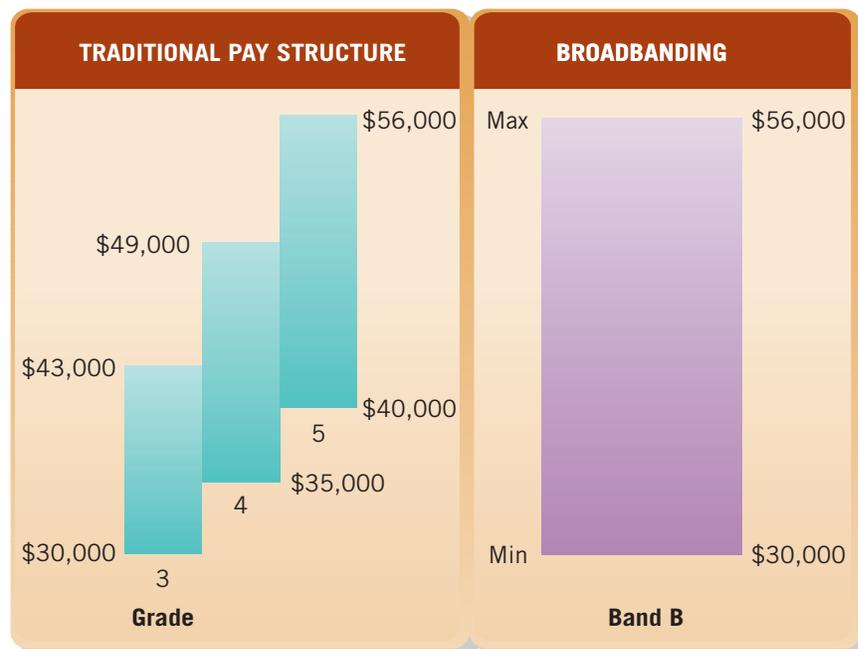
shift responsibilities as market conditions and organizational needs change. Traditional questions from employees about when a promotion to a new grade occurs, and what pay adjustments will be made for temporarily performing some new job responsibilities, are unnecessary.[8]

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

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

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

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

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

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

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

The various types and facets of variable pay are discussed in the next chapter. But it is important to monitor the shift toward compensation being allocated

HR PERSPECTIVE

Team-Based Rewards

As more organizations have established work teams, they have developed team-based reward systems. Several company examples illustrate some of the factors associated with having a successful team-based compensation program.

At Libby, Inc., workers at its Toledo, Ohio, manufacturing plants set plant goals. These goals then are used to peg 60% of performance targets, while the other 40% are based on corporate operations and improvements in income. The plants use cross-functional teams for the production work, and a gainsharing program has been established that provides variable pay based on per-

formance against those goals. The program illustrates the importance of using business unit goals, not just corporate or team goals.

Base pay for teams is generally recommended to be built on a skill-based system of competencies. Teams at Eastman Chemical Company in Tennessee have a pay program for applied knowledge and skills set up in six levels.

But team-based pay does not always succeed easily. At a Frito-Lay facility in Missouri, the team-based compensation program was installed by management in the plant. Training in "team behavior" was necessary to change the organizational

culture. All went satisfactorily until an announcement was made that the pay program was being changed from pay raises being given across-the-board to a pay-for-performance system using team member input. Many workers objected to their team members influencing pay decisions, and the plant management had to defer implementing team-based rewards. This experience illustrates that team-based compensation should be used only when the organizational culture is compatible with it, and there has been extensive employee involvement and acceptance.[11]

through such plans, rather than the organization relying solely on base pay to reward employees at all levels for attaining strategic organizational objectives.

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

Many organizations use team rewards as variable pay above base pay. For base pay, individuals are compensated using competency- or skill-based approaches. A study of organizations using team-based rewards, and of individuals serving on the teams, identified that team rewards are most frequently distributed annually (58%) as a specified dollar amount (56%), not as a percentage of base pay (44%).[12]

Based on experiences in the team-based environment, as the HR Perspective illustrates, several factors should be considered when using team-based reward systems:[13]

- Use skill-based pay for the base.
- Make the system simple and understandable.
- Use variable pay based on business entity performance.
- Distribute rewards at the team level.
- Have a high degree of employee involvement.

In summary, the most successful uses of team-based compensation have been as variable pay on top of base pay. Rather than substituting for base pay programs, team-based rewards appear to be useful in rewarding performance of a team beyond the satisfactory level. More discussion on team-based incentives is contained in the next chapter.

Behavioral Aspects of Compensation

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

Equity

Equity
The perceived fairness of the relation between what a person does (inputs) and what the person receives (outcomes).

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

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

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

Procedural justice
The perceived fairness of the process and procedures used to make decisions about employees.

Procedural justice is the perceived fairness of the process and procedures used to make decisions about employees, including their pay. Procedural fairness is viewed both in terms of the policies and procedures and the actions of supervisors and managers who implement the policies and procedures.[14] As it applies to compensation, the process of determining the base pay for jobs, the allocation of pay increases, and the measurement of performance must be perceived as fair. Two critical issues are (1) how appropriate and fair is the process used to assign jobs to pay grades? and (2) how are the pay ranges for those jobs established?

Distributive justice
The perceived fairness in the distribution of outcomes.

Another related issue that must be considered is **distributive justice,** which refers to the perceived fairness of the amounts given for performance. This facet of equity refers to how pay relates to performance. For instance, if a hard-working employee whose performance is outstanding receives the same across-the-board raise as an employee with attendance problems and mediocre perfor-

FIGURE 13–7 *Equity Considerations in Compensation*
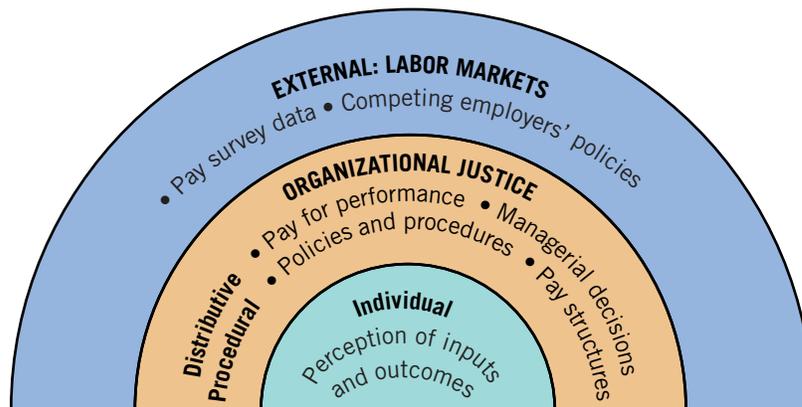
mance, then greater inequity may be perceived. Likewise, if two employees have similar performance records but one receives a significantly greater pay raise, the other one may perceive that the inequity is due to supervisory favoritism or other factors not related to the job.

To address concerns about justice, some organizations establish *appeals procedures*. In public-sector organizations, appeals procedures usually are identified formally, whereas in private-sector firms they are usually more informal. Typically, employees can contact the HR department after they have discussed their concerns with their immediate supervisors and managers.

PAY OPENNESS Another equity issue concerns the degree of openness or secrecy that organizations allow regarding their pay systems. Pay information kept secret in "closed" systems includes how much others make, what raises others have received, and even what pay grades and ranges exist in the organization.

A growing number of organizations are opening up their pay systems to some degree by informing employees of compensation policies, providing a general description of the basis for the compensation system, and indicating where an individual's pay is within a pay grade. Such information allows employees to make more accurate equity comparisons. It is crucial in an open pay system that managers be able to explain satisfactorily any pay differences that exist.

EXTERNAL EQUITY Externally, the organization must provide compensation that is seen as equitable in relation to the compensation provided employees performing similar jobs in other organizations. If an employer does not provide compensation that is viewed as fair by its employees, that organization may have higher turnover of employees, may have more difficulty recruiting qualified and scarce-skill employees, and may attract and retain individuals with less knowledge, skills, and abilities, resulting in lower overall organizational productivity. Organizations track external equity by using pay surveys, which are discussed later in the chapter.

Importance of Equity and Compensation Activities

It is important for HR professionals and managers to develop, administer, and maintain compensation programs that are perceived equitably by employees. The

consequence of an equitable compensation program is that individuals are more likely to be attracted to and take jobs in organizations where employees do not voice widespread concerns about equity. Greater loyalty, less turnover, and higher commitment to achieve organizational performance objectives are more likely if employees believe they are compensated fairly and will share in the growth of the organization. Also, the organization must have policies, procedures, and administrative support systems that are viewed as job-related and are not manipulated by favoritism or personality preferences of managers and supervisors.

Finally, external equity is crucial if the organization is going to compete effectively in the labor market. Increasingly in many labor markets, some employers are finding it difficult to attract and retain a workforce with the necessary capabilities to compete in a global marketplace. Regularly tracking external pay data and updating pay structures are integral to ensuring external equity in any organization.

Legal Constraints on Pay Systems

Compensation systems must comply with a myriad of government constraints. Minimum wage standards and hours of work are two important areas addressed by the laws. The following discussion examines the laws and regulations affecting base compensation; laws and regulations affecting incentives and benefits are examined in later chapters.

Fair Labor Standards Act (FLSA)

LOGGING ON . . .

Information on Fair Labor Standards Act

This web site includes background information on Fair Labor Standards Act provisions affecting compensation policies and practices.

http://humanresources.ucr. edu/hrunits/compensation/ FLSA.htm

The major law affecting compensation is the Fair Labor Standards Act (FLSA). Passed in 1938, the FLSA has been amended several times to raise minimum wage rates and expand employers covered. Unless otherwise noted in the discussion that follows, both private- and public-sector employers are affected by the act. Generally, private-sector employers engaged in interstate commerce and retail service firms with two or more employees and gross sales of at least $500,000 per year are covered by the act. Very small, family-owned and -operated entities and family farms generally are excluded from coverage. Most federal, state, and local government employers are also subject to the provisions of the act, except for military personnel, volunteer workers, and a few other limited groups.[15]

Compliance with FLSA provisions is enforced by the Wage and Hour Division of the U.S. Department of Labor. To meet FLSA requirements employers must keep accurate time records and maintain these records for three years. Inspectors from the Wage and Hour Division investigate complaints filed by individuals who believe they have not received the overtime payments due them. Also, certain industries that historically have had a large number of wage and hour violations can be targeted, and firms in those industries can be investigated. Penalties for wage and hour violations often include awards of back pay for affected current and former employees for up to *two years*.

The act has three major objectives:

● Establish a minimum wage floor.
● Discourage oppressive use of child labor.
● Encourage limits on the number of weekly hours employees work through overtime provisions (exempt and nonexempt status).

HR PERSPECTIVE

Ethical Debate on a Minimum Wage vs. a "Living" Wage

Since 1938 when the Fair Labor Standards Act was passed, a minimum wage has been in existence in the United States. First established at 25¢/hour, the minimum wage has increased significantly. But the concept of a minimum wage and an appropriate level for it have been subjects of considerable debate by economists, politicians, employers, unions, and others. One view of the minimum wage is that it should be set at a relatively low level, so that smaller employers can afford to hire workers. Also, having a lower minimum wage encourages employers to hire workers with minimal work histories and those with limited knowledge, skills and abilities (KSAs).

Considerable research has been done regarding the effects of raising the minimum wage on the creation of new jobs and job opportunities for lower-skilled workers. The research results generally have been mixed: Some studies show that a minimum-wage increase reduces job opportunities for some workers; other studies show little impact. Obviously, the overall state of the U.S. economy is a major mediating factor.

A new dimension to the debate on minimum wage has emerged in the past few years: the concept of a "living wage." Some politicians in the United States and other countries with minimum-wage laws have argued that the minimum wage should be set at a level that provides a living wage for workers. In the United States the living-wage level typically has been identified as the amount needed for a family of four to be supported by one worker so that family income is above the officially identified "poverty" level. Currently in the United States, that is about $7.50/hour, which is significantly higher than the current minimum wage.

A number of cities have not waited for U.S. federal laws to change and they have passed living-wage laws. Here are some examples:

Baltimore, MD: $7.50/hour
Duluth, MN: $7.25 or $6.50 plus
    health insurance
Los Angeles, CA: $7.25 with benefits or $8.50 without benefits

Other cities—such as Boston, MA; Minneapolis, MN; and New Haven, CT—require a living-wage minimum at 100% or more of the poverty level established by U.S. government statistics.

Those favoring living-wage laws stress that they are needed so that even the lowest-skilled workers can earn wages above the poverty level. Those opposed to living-wage laws point out that because many of the lowest-paid workers are single, using the "family of four" test is inappropriate. Obviously there are ethical, economic, and employment implications on both sides of this issue. What do you think?[16]

MINIMUM WAGE The FLSA sets a minimum wage to be paid to the broad spectrum of covered employees. The actual minimum wage can be changed only by congressional action. A lower minimum-wage level is set for "tipped" employees who work in such firms as restaurants, but their payment must at least equal the minimum wage when *average* tips are included. The level at which the minimum wage should be set has led to significant political discussions and legislative maneuvering. But, as the HR Perspective indicates, some ethical issues are being debated regarding the purpose of the minimum wage and how it should be changed.

CHILD-LABOR PROVISIONS The child-labor provisions of the FLSA set the minimum age for employment with unlimited hours at 16 years. For hazardous occupations (see Chapter 16), the minimum is 18 years of age. Those aged 14 to 15 years old may work outside school hours with certain limitations.

Many employers require age certificates for employees because the FLSA places the responsibility on the employer to determine an individual's age.[17] The certificates may be issued by a representative of a state labor department, a state education department, or a local school district.

Exempt employees
Employees to whom employers are not required to pay overtime under the Fair Labor Standards Act.

Nonexempt employees
Employees who must be paid overtime under the Fair Labor Standards Act.

EXEMPT AND NONEXEMPT STATUS Under the FLSA, employees are classified as exempt or nonexempt. **Exempt** employees are those who hold positions classified as *executive, administrative, professional,* or *outside sales,* to whom employers are not required to pay overtime. **Nonexempt** employees are those who must be paid overtime under the Fair Labor Standards Act.

In base pay programs, employers often categorize jobs into three different groupings that tie the FLSA status and the method of payment together:

- Hourly
- Salaried-nonexempt
- Salaried-exempt

Hourly jobs require employers to pay overtime and comply with the FLSA. Each salaried position must be identified as *salaried-exempt* or *salaried-nonexempt.* Employees in positions classified as salaried-nonexempt are covered by the overtime provisions of the FLSA and therefore must be paid overtime. Salaried-nonexempt positions sometimes include secretarial, clerical, and salaried blue-collar positions.

Salaried-exempt employees are not required by the FLSA to be paid overtime, although some organizations have implemented policies to pay a straight rate for extensive hours of overtime. For instance, some electric utilities pay first-line supervisors extra using a special rate for hours worked over 50 per week during storm emergencies. A growing number of salaried-exempt information professionals also receive additional compensation for working extensive hours.

Three major factors are considered in determining whether an individual holds an exempt position:

- Discretionary authority for independent action
- Percentage of time spent performing routine, manual, or clerical work
- Earnings level

Figure 13–8 shows the impact of these factors on each type of exemption. It is useful to note that the earnings levels are basically meaningless, because they have not changed in years despite increases in the minimum wage. These inconsistencies are due to political disagreements among employers, unions, legislators, and federal regulations.

COMPUTER-RELATED OCCUPATIONS Due to the growth of information systems and computer jobs, a special category of professionals was added in 1990. For those working in computer-related occupations who are paid at least the equivalent of $27.63 per hour on a salaried basis, the FLSA does not require overtime pay. Because the wage level in this case is set at approximately $58,000 per year, a limited number of jobs and individuals are affected. For all other occupations, the FLSA has no set dollar level above which overtime is not required.

BNA:

Regular Pay and Overtime
To review FLSA regulations on determining regular base pay rates and overtime rate determination considering several factors, see 2035.10–2035.70.

OVERTIME PROVISIONS The FLSA establishes overtime pay requirements. Its provisions set overtime pay at one and one-half times the regular pay rate for all hours in excess of 40 per week, except for employees who are not covered by the FLSA. Overtime provisions do not apply to farm workers, who also have a lower minimum-wage schedule.

The work week is defined as a consecutive period of 168 hours (24 hours × 7 days) and does not have to be a calendar week. Hospitals are allowed to use a 14-day period instead of a 7-day week as long as overtime is paid for hours worked

FIGURE 13–8 *Wage/Hour Status Under Fair Labor Standards Act*

Exemption Category	A Discretionary Authority	B Percent of Time	C Earnings Levels
Executive	1. Primary duty is managing 2. Regularly directs work of at least two others 3. Authority to hire/fire or recommend these	1. Must spend 20% or less time doing clerical, manual, routine work (less than 40% in retail or service establishments)	1. Paid salary at $155/wk or $250/wk if meets A1–A2
Administrative	1. Primarily responsible for nonmanual or office work related to management policies 2. Regularly exercises discretion and independent judgment and makes important decisions 3. Regularly assists executives and works under general supervision	1. Must spend 20% or less time doing clerical, manual, routine work (less than 40% in retail or service establishments)	1. Paid salary at $155/wk or $250/wk if meets A1–A2
Professional	1. Performs work requiring knowledge of an advanced field *or* creative and original artistic work *or* works as teacher in educational system 2. Must do work that is predominantly intellectual and varied	1. Must spend 20% or less time doing nonprofessional work	1. Paid salary at least $170/wk or $250/wk if meets A1
Outside Sales	1. Customarily works away from employer site *and* 2. Sells tangible or intangible items *or* 3. Obtains orders or contracts for services	1. Must spend 20% or less time doing work other than outside selling	1. No salary test

NOTE: For more details, see *Executive, Administrative, Professional, and Outside Sales Exemptions under the Fair Labor Standards Act,* WH Publication no. 1363 (Washington, DC: U.S. Department of Labor, Employment Standards Administration, Wage and Hour Division).

beyond 8 in a day or 80 in a 14-day period. No daily number of hours requiring overtime is set, except for special provisions relating to hospitals and other specially designated organizations. Thus, if a manufacturing firm has a 4-day/10-hour schedule, no overtime pay is required by the act.

COMPENSATORY TIME OFF Often called *comp-time,* **compensatory time off** is given in lieu of payment for extra time worked. However, unless it is given at the rate of one and one-half times the hours worked over a 40-hour week, comp-time is illegal in the private sector. Also, comp-time cannot be carried over from one pay period to another.

    The only major exception to those provisions is for public-sector employees, such as fire and police employees, and a limited number of other workers. Because they often are on 24-hour duty, these individuals may receive compen-

Compensatory time off
That given in lieu of payment for extra time worked.

satory time off. Police and fire officers can accumulate up to 480 hours; all other covered public-sector employees can accumulate up to 240 hours. When those hours are used, the employees must be paid their normal rates of pay, and the comp-time hours used *do not* count as hours worked in the paid week.

Independent Contractor Regulations

The growing use of contingent workers by many organizations has called attention to another group of legal regulations—those identifying the criteria that independent contractors must meet. Classifying someone as an independent contractor rather than an employee offers two primary advantages.[18] First, the employer does not have to pay Social Security, unemployment, or workers' compensation costs. These additional payroll levies could add 10% or more to the costs of hiring the individual as an employee. Second, if the person is classified as an employee and is doing a job considered nonexempt under the federal Fair Labor Standards Act, then the employer may be responsible for overtime pay at the rate of time-and-a-half for any week in which the person works more than 40 hours.

The criteria for deciding independent contractor status have been identified by the Internal Revenue Service (IRS), and most other federal and state entities rely on those criteria. The IRS has identified 20 factors that must be considered in making such a determination. Figure 13–9 illustrates some of the key differences between an employee and an independent contractor.

Acts Affecting Government Contractors

Several compensation-related acts apply to firms having contracts with the U.S. government. The first one passed was the *Davis-Bacon Act of 1931,* which affects compensation paid by firms engaged in federal construction projects valued in excess of $2,000. It deals only with federal construction projects and requires that the "prevailing" wage rate be paid on all federal construction projects. The

FIGURE 13–9 *Employees or Independent Contractors?—The IRS Test*

An Employee	An Independent Contractor
• Must comply with instructions about when, where, and how to work • Renders services personally • Has a continuing relationship with an employer • Usually works on the premises of the employer • Normally is furnished significant tools, materials, and other equipment by the employer • Can be fired by an employer • Can quit at any time without incurring liability	• Can hire, supervise, and pay assistants • Generally can set his or her own hours • Usually is paid by the job or on straight commission • Has made a significant investment in facilities • Can make a profit or suffer a loss • Generally is free to provide services to two or more unrelated persons or firms at the same time • Makes his or her services available to the public

SOURCE: Internal Revenue Service

prevailing wage is determined by a formula that considers the rate paid for a job by a majority of the employers in the appropriate geographic area.

Two other acts require firms with *federal supply or service contracts* exceeding $10,000 to pay a prevailing wage. Both the *Walsh-Healy Public Contracts Act* and the *Service Contracts Act* apply only to those who are working directly on a federal government contract or who substantially affect its performance.

Equal Pay and Pay Equity

Various legislative efforts have addressed the issue of wage discrimination on the basis of gender. The Equal Pay Act was passed as a major amendment to the FLSA in 1963. The original act and subsequent amendments focus on wage discrimination on the basis of sex. The act applies to both men and women and prohibits paying different wage scales to men and women performing substantially the same jobs. Pay differences are justifiable on the basis of merit (better performance), seniority (longer service), quantity or quality of work, or any factor other than sex. Similar pay must be given for jobs requiring equal skills, equal effort, or equal responsibility or jobs done under similar working conditions.

Most of the equal-pay cases decided in court have involved situations in which women were paid less than men for doing similar work, though under different job titles. For example, equal-pay violations have been found in health-care institutions in which male "physician assistants" were paid significantly more than females with equal experience and qualifications who were called "nurse practitioners" but performed the same job duties.

There has been growing pressure to pay jobs requiring comparable capabilities similarly even if actual duties and market rates vary. Growing concerns about *comparable worth* have been translated into laws designed to address disparities between the pay levels of men and women. These laws focus on public-sector jobs, especially those in state governments. States with comparable-worth laws include Hawaii, Iowa, Maine, Michigan, Minnesota, Montana, Ohio, Oregon, Washington, and Wisconsin.

Pay equity is a different issue from that of equal pay for equal work. **Pay equity** is the concept that the pay for all jobs requiring comparable knowledge, skills, and abilities should be similar even if actual duties and market rates differ significantly. Except where state (in the United States) or provincial (in Canada) laws have required pay equity, simply showing that there are pay differences for jobs that are different has not been sufficient to prove discrimination in court.

Pay equity
Similarity in pay for all jobs requiring comparable levels of knowledge, skills, and abilities, even if actual duties and market rates differ significantly.

Because the U.S. Supreme Court and other lower-court decisions generally have not supported the concept of pay equity, some advocacy groups have urged passage of a federal act mandating pay equity.[19] For instance, in 1997 a bill called the Fair Pay Act was introduced in the U.S. Senate, but it has not been passed into law.

State Laws

Modified versions of federal compensation laws have been enacted by many state and municipal government bodies. These laws tend to cover workers included in intrastate commerce not covered by federal law. If a state has a higher minimum wage than that set under the Fair Labor Standards Act, the higher figure becomes the required minimum wage.

Many states once had laws that limited the number of hours women could work. However, these laws generally have been held to be discriminatory in a variety of court cases. Consequently, most states have dropped such laws.

Garnishment Laws

Garnishment
A court action in which a portion of an employee's wages is set aside to pay a debt owed a creditor.

Garnishment of an employee's wage occurs when a creditor obtains a court order that directs an employer to submit a part of the employee's pay to the creditor for debts owed by the employee. Regulations passed as a part of the Consumer Credit Protection Act established limitations on the amount of wages that can be garnished and restricted the right of employers to discharge employees whose pay is subject to a single garnishment order. All 50 states have laws applying to wage garnishments.

Wage and Salary Administration

Wage and salary administration
Activities involved in the development, implementation, and maintenance of a base pay system.

The development, implementation, and ongoing maintenance of a base pay system usually is described as **wage and salary administration.** The purpose of wage and salary administration is to provide pay that is both competitive and equitable. Underlying the administered activities are pay policies that set the overall direction of pay within the organization.
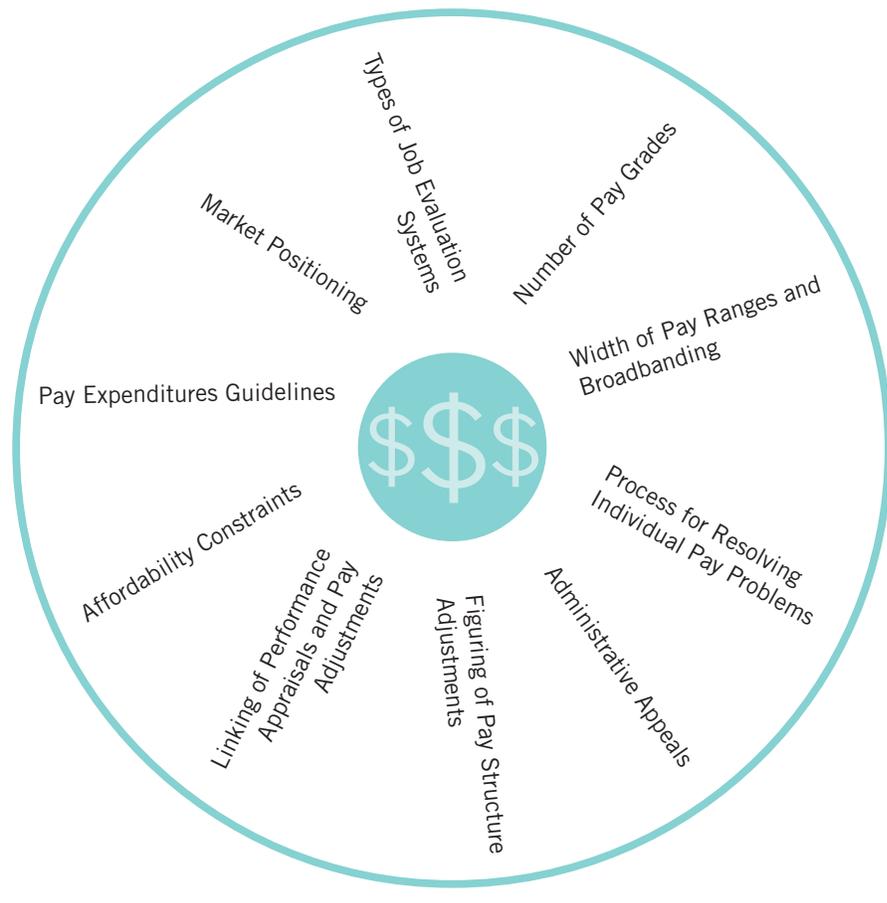
Pay Policies

Organizations must develop policies as general guidelines to provide for coordination, consistency, and fairness in compensating employees. The pay policies are an outgrowth of the answers to the compensation philosophy issues discussed earlier. For example, following a pay-for-performance philosophy requires incorporating performance appraisal results into the pay adjustment process. However, a more entitlement-oriented philosophy will require developing policies in automatic step increases based on length of service for hourly employees. Figure 13–10 identifies some questions about pay policy organizations must address. Many of these items are mentioned in the discussion that follows.

MARKET POSITIONING A major policy decision must be made about the comparative level of pay the organization wants to maintain. Specifically, an employer must identify how competitive it wishes to be in the market for employees. Organizations usually want to "pay market"—that is, to *match* the "going rates" paid to employees by competitive organizations in order to ensure external equity.

Some organizations choose to *lead* the market by paying above-market rates. This policy aids in attracting and retaining employees. One transportation firm that pays about 10% to 15% above local-market medians for clerical employees consistently has a waiting list for qualified word processing workers and other specialized office workers. By paying above market, the firm feels that it also deters efforts of its office workers to unionize.

In contrast, some employers may deliberately choose to *lag* the market by paying below market. If there is an excess of qualified workers in an area, an adequate number of people are willing to work for lower pay. Also, organizations in declining industries and some small businesses may not be able to afford to pay

FIGURE 13–10 *Pay Policies Considerations*

Types of Job Evaluation Systems

Market Positioning

Number of Pay Grades

Pay Expenditures Guidelines

Width of Pay Ranges and Broadbanding

$$$

Affordability Constraints

Process for Resolving Individual Pay Problems

Linking of Performance Appraisals and Pay Adjustments

Figuring of Pay Structure Adjustments

Administrative Appeals

going rates because of financial pressures. However, paying rates below market can result in higher turnover or in having to hire less-qualified employees.

MARKET PRICING Some employers do not establish a formal wage and salary system. Smaller employers particularly may assume that the pay set by other employers is an accurate reflection of a job's worth, so they set their pay rates at **market price,** the typical wage paid for a job in the immediate labor market.

One difficulty with this approach is the assumption that jobs are the same from organization to organization, which is not necessarily the case. Also, obtaining market information often means calling one or two other firms, which may not give an accurate picture of the market. Further, direct market pricing does not adequately consider the impact of economic conditions, employer size, and other variables. Consequently, more complex methods have been developed.

Market price
Typical wage paid for a job in the immediate labor market.

Unions and Compensation

A major variable affecting an employer's pay policies is whether any employees are represented by a labor union. In nonunion organizations, employers have

significantly more flexibility in determining pay levels and policies. Unionized employees usually have their pay set according to the terms of a collective bargaining contract between their employer and the union that represents them. Because pay is a visible issue, it is natural for unions to emphasize pay levels.

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

Development of a Base Pay System

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

As Figure 13–11 shows, the development of a wage and salary system assumes that accurate job descriptions and job specifications are available. The job

FIGURE 13–11 *Compensation Administration Process*
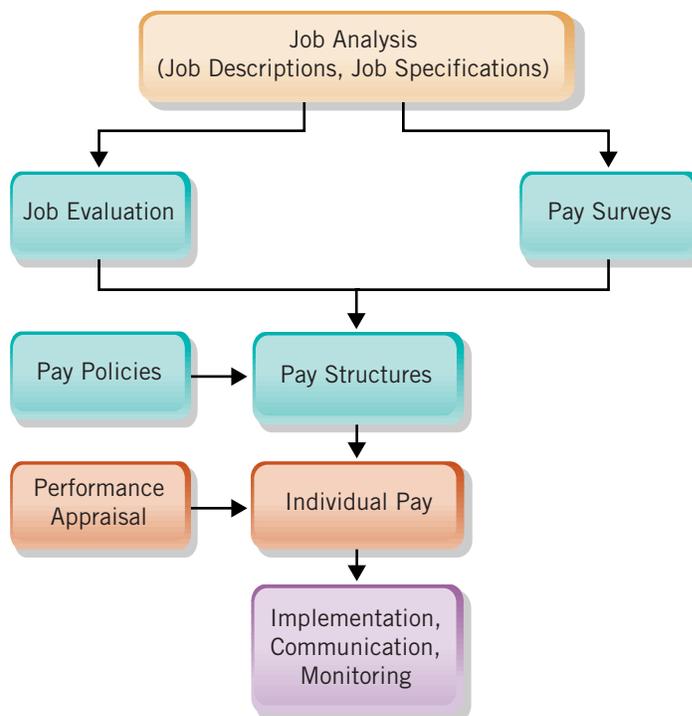
descriptions then are used in two activities: *job evaluation* and *pay surveys*. These activities are designed to ensure that the pay system is both internally equitable and externally competitive. The data compiled in these two activities are used to design *pay structures,* including *pay grades* and minimum-to-maximum *pay ranges.* After the pay structures have been developed, individual jobs must be placed in the appropriate pay grades and employees' pay adjusted based on length of service and performance. Finally, the pay system must be monitored and updated.

Job Evaluation

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

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

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

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

RANKING METHOD The ranking method is one of the simplest methods of job evaluation. It places jobs in order, ranging from highest to lowest in value to the organization. The entire job is considered rather than the individual components.[20] Several different methods of ranking are available, but all present problems.

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

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

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

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

Benchmark job
Job found in many organizations and performed by several individuals who have similar duties that are relatively stable and require similar KSAs.

Another problem with the classification method is that it relies heavily on job titles and duties and assumes that they are similar from one organization to another. For these reasons, many federal, state, and local government entities, which traditionally used the classification method, have shifted to point systems.

Compensable factor
That used to identify a job value that is commonly present throughout a group of jobs.

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

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

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

Know-How	**Problem Solving**	**Accountability**
• Functional expertise	• Environment	• Freedom to act
• Managerial skills	• Challenge	• Impact of end results
• Human relations		• Magnitude

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

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

One major drawback to the point method is the time needed to develop a system. For this reason, employers often use manuals and systems developed by management consultants or other organizations. Point systems have also been criticized for reinforcing traditional organizational structures and job rigidity.

FIGURE 13–12 *Job Evaluation Point Chart*

	CLERICAL GROUP			
Factor	**1st Degree Points**	**2nd Degree Points**	**3rd Degree Points**	**4th Degree Points**
1. Education	14	28	42	56
2. Experience	22	44	66	88
3. Initiative and ingenuity	14	28	42	56
4. Contacts with others	14	28	42	56
Responsibility				
5. Supervision received	10	20	35	50
6. Latitude and depth	20	40	70	100
7. Work of others	5	10	15	20
8. Trust imposed	10	20	35	50
9. Performance	7	14	21	28
Other				
10. Work environment	10	25	45	
11. Mental or visual demand	10	20	35	
12. Physical effort	28			

*The specific degrees and points for education are as follows:
Education is the basic prerequisite knowledge essential to satisfactorily perform the job. This knowledge may have been acquired through formal schooling, as well as correspondence courses, company education programs, or through equivalent experience in allied fields. Analyze the minimum requirements of the job and not the formal education of individuals performing it.
1st Degree—Requires knowledge usually equivalent to a two-year high school education. Requires ability to read, write, and follow simple written or oral instructions and to use simple arithmetic processes involving counting, adding, subtracting, dividing, and multiplying whole numbers. May require basic typing ability.
2nd Degree—Requires knowledge equivalent to a four-year high school education. Requires ability to perform advanced arithmetic process involving adding, subtracting, dividing, and multiplying or decimals and fractions and ability to maintain or prepare routine correspondence, records, and reports. May require knowledge of advanced typing and/or basic knowledge of bookkeeping, drafting, etc.
3rdDegree—Requires knowledge equivalent to a four-year high school education plus some specialized knowledge/training in a particular field, such as elementary accounting; or general blueprint reading or engineering practices.
4th Degree—Requires knowledge equivalent to two years of college education. Requires ability to understand and perform work involving general engineering or accounting theory. Requires ability to originate and compile statistics and interpretive reports and prepare correspondence of a difficult or technical nature.

Although not perfect, the point method of job evaluation generally is better than the classification and ranking methods because it quantifies job elements.

FACTOR COMPARISON The factor-comparison method is a quantitative and complex combination of the ranking and point methods. It involves first determining the benchmark jobs in an organization, selecting compensable factors, and ranking all benchmark jobs factor by factor. Next, the jobs are compared with market rates for benchmark jobs, and monetary values are assigned to each factor. The final step is to evaluate all other jobs in the organization by comparing them with the benchmark jobs.

A major advantage of the factor-comparison method is that it is tailored specifically to one organization. Each organization must develop its own key jobs and its own factors. For this reason, buying a packaged system may not be

appropriate. Further, factor comparison not only tells which jobs are worth more but also indicates how much more, so that factor values can be more easily converted to monetary wages.

The major disadvantages of the factor-comparison method are its difficulty and complexity. It is not an easy system to explain to employees, and it is time consuming to establish and develop. Also, a factor-comparison system may not be appropriate for an organization with many similar types of jobs. Managers attempting to use the method should consult a specialist or one of the more detailed compensation books or manuals that discuss the method.

INTEGRATED AND COMPUTERIZED JOB EVALUATION Increasingly, organizations are linking the components of wage and salary programs through computerized and statistical techniques. Using a bank of compensable factors, employers can select those factors that are most relevant for the different job families in the organization. Then these integrated systems can perform the following tasks:

- Create job descriptions that identify the compensable functions for each job.
- Link to pay survey data available on the Internet.
- Use multiple regression and other statistical methods to analyze job evaluation and pay survey relationships.
- Compare current employee pay levels in a database to the job evaluation and pay survey data.
- Develop costing models and budgetary implications of various implementation approaches.

Because of the advanced expertise needed to develop and computerize the integrated systems, management consultants are the primary source for them. These systems really are less a separate method and more an application of information technology and advanced statistics to the process of developing a wage and salary program. Integrated systems, including the consulting expertise necessary to work through and implement them, are relatively expensive to purchase. Therefore they generally are used only by medium- to large-sized employers.

Legal Issues and Job Evaluation

Employers usually view evaluating jobs to determine rates of pay as a separate issue from selecting individuals for those jobs or taking disciplinary action against individuals. But because job evaluation affects the employment relationship, specifically the pay of individuals, it involves legal issues that must be addressed.

JOB EVALUATION AND THE AMERICANS WITH DISABILITIES ACT (ADA) As emphasized in Chapter 7, the Americans with Disabilities Act requires employers to identify the essential functions of a job. However, all facets of jobs are examined during a job evaluation. For instance, assume a production job requires a punch press operator to drill holes in parts and place them in a bin of finished products. Every three hours the operator must push that bin, which may weigh two hundred pounds or more, to the packaging area. The movement of the bin probably is not an essential function. But if job evaluation considers the physical demands associated with pushing the bin, then the points assigned may be different from the points that would be assigned if only the essential functions were considered.

GENDER ISSUES AND JOB EVALUATION Critics have charged that traditional job evaluation programs place less weight on knowledge, skills, and working

conditions for many female-dominated jobs in office and clerical areas than on the same factors for male-dominated jobs in craft and manufacturing areas. Also, jobs typically are compared only with others in the same job "family." As discussed earlier, advocates of pay equity view the disparity between men's jobs and women's jobs as evidence of gender discrimination. These advocates also have attacked typical job evaluations as being gender biased.

Employers counter that because they base their pay rates heavily on external equity comparisons in the labor market, they are not the ones who are discriminating; they are just reflecting rates the "market economy" sets for jobs and workers. A number of different methodologies can be used to evaluate the differences in pay based on gender.[24] Undoubtedly, with further developments in court decisions, government actions, and research, job evaluation activities will face more pressures to address gender differences.

Pay Surveys

Another part of building a pay system is surveying the pay that other organizations provide for similar jobs. A **pay survey** is a collection of data on compensation rates for workers performing similar jobs in other organizations. An employer may use surveys conducted by other organizations, or it may decide to conduct its own survey.

Pay survey
A collection of data on existing compensation rates for workers performing similar jobs in other organizations.

USING PREPARED PAY SURVEYS Many different surveys are available from a variety of sources. As the HR Perspective indicates, the growth of the Internet has resulted in a large amount of pay survey sources and data being available on-line. Whether available electronically or in printed form, national surveys on many jobs and industries come from the U.S. Department of Labor, Bureau of Labor Statistics, and through national trade associations. In many communities, employers participate in a wage survey sponsored by the local Chamber of Commerce to provide information to new employers interested in locating in the community.

When using surveys from other sources, it is important to use them properly. Some questions to be addressed before using a survey are:

- *Participants:*   Is the survey a realistic sample of those employers with whom the organization competes for employees?
- *Broad-based:*   Is the survey balanced so that organizations of varying sizes, industries, and locales are included?
- *Timeliness:*   How current is the data (determined by the date when the survey was conducted)?
- *Methodology:*   How established is the survey, and how qualified are those who conducted it?
- *Job matches:*   Does it contain job summaries so that appropriate matches to organization job descriptions can be made?

LOGGING ON . . .
Pay Survey Sources
Sources are identified and reviewed by the Institute of Management & Administration, Inc. at:

http://www.ioma.com

DEVELOPING A PAY SURVEY If needed pay information is not already available, the employer can undertake its own pay survey. Employers with comparable positions should be selected. Employers considered to be "representative" should also be surveyed. Even if the employer conducting the survey is not unionized, the pay survey probably should examine union as well as nonunion organizations. Developing pay competitive with union wages may deter employees from joining a union.

HR PERSPECTIVE

The Internet and Pay Survey Data

The growth of the Internet has provided HR professionals expanded access to pay survey data. There are numerous ways to access electronic pay surveys done by governmental entities, associations, and consulting firms. Following are some useful World Wide Web sites, with the specific web addresses in parentheses.

Many surveys that are conducted by governmental agencies can be tapped using web sources. Here are some useful federal and state government sources for pay survey data:

- *U.S. Department of Labor, Bureau of Labor Statistics (BLS):* By starting at the BLS home page (www.bls.gov), users can then move to a search by states, occupational titles, covered employment, and wages.
- *U.S. Securities and Exchange Commission:* This web site gives pay data for some executive salaries (www.sec.gov).
- *State Governments:* Many states compile pay survey data that can be accessed on the web.

For example, see New York (www.labor.state.ny/wages/man.htm) and South Dakota (www.state.sd.us/dol).

Many private-sector survey sources also provide pay survey data on the web. Many of them require users to pay subscription fees to access the actual data banks. One useful general source is the American Compensation Association (www.acaonline.org). Another web site that reviews the executive pay and incentives of 300 CEOs is compiled by the AFL-CIO union organization (www.aflcio.paywatch.org).

Consulting firms are a major source of pay survey data on the web. Many firms, both large and small, conduct annual surveys on various industries, job fields, and geographic regions. Some of the more prominent ones are William M. Mercer, Inc. (www.mercer.com); Watson, Wyatt Worldwide (www.watsonwyatt.com); Hewitt Associates (www.hewitt.com); and Hay Group (www.haygroup.com). Various

professional and trade associations also have pay survey data available. A few examples are

- *Computer professionals:* Pencom (www.pencomsi.com)
- *Accounting:* ACSYS Resources, Inc. (www.ascysresources.com/acct.htm)
- *Advertising:* Ad Age Data Place (www.adage.com/egibin/)

Even international pay survey data can be obtained electronically. For instance, if data on pay in the United Kingdom is needed, an international HR professional can access the Eclipse Group, a private source for pay survey data at (www.ireclipse.co.uk). Or, for data in Venezuela, try a government site at (www.ocei.gov.ve).

This brief discussion illustrates that pay survey data that was formerly available only in printed form now can be downloaded from electronic sources. These electronic sources definitely provide greater access to data.[23]

Jobs to be surveyed also must be determined. Because not all of the jobs in all organizations can be surveyed, those designing the pay survey should select jobs that can be easily compared, have common job elements, and represent a broad range of jobs. Key or benchmark jobs are especially important ones to include. It is also advisable to provide brief job descriptions for jobs surveyed in order to ensure more accurate matches. For executive-level jobs, data on total compensation (base pay and bonuses) is often gathered as well.

In the next phase of designing the pay survey, managers decide what information is needed for various jobs. Information such as starting pay, base pay, overtime rate, vacation and holiday pay policies, and bonuses all can be included in a survey. However, requesting too much information may discourage survey returns.

The results of the pay survey usually are made available to those participating in the survey in order to gain their cooperation. Most surveys specify confidentiality, and data is summarized to assure anonymity. Different job levels often are

included, and the pay rates are presented both in overall terms and on a city-by-city basis to reflect regional differences in pay.

There has been some debate about how essential pay survey data will continue to be, as jobs continue to change and more "hybrid" jobs that are combinations of traditional jobs emerge.[25] Also, as more disparate jobs are placed into broader pay bands, the difficulty of comparing diverse jobs increases.[26]

LEGAL ISSUES AND PAY SURVEYS One reason for employers to use outside consultants to conduct pay surveys is to avoid charges that the employers are attempting "price-fixing" on wages. The federal government has filed suit in the past alleging that by sharing wage data, employers may be attempting to hold wages down artificially in violation of the Sherman Anti-Trust Act.

A key case involved the Utah Society for Healthcare Human Resource Administration and nine hospitals in the Salt Lake City area. The consent decree that resulted prohibits all health-care facilities in Utah from designing, developing, or conducting a wage survey. The hospitals can participate in surveys conducted by independent third-party firms only if privacy safeguards are met. Specifically, only aggregate data that is summarized may be provided, and no data from an individual firm may be identified.[27] As a result, it is likely that fewer firms will conduct their own surveys, and the use of outside consultants to do pay surveys will continue to grow.

Pay Structures

Once survey data has been gathered, pay structures can be developed by the process depicted in Figure 13–13 on the next page. As indicated in that figure, one means of tying pay survey information to job evaluation data is to plot a *wage curve,* or *scattergram.* This plotting involves first making a graph that charts job evaluation points and pay survey rates for all surveyed jobs. In this way, the distribution of pay for surveyed jobs can be shown, and a linear trend line can be developed by use of the *least-squares regression method.* Also, a curvilinear line can be developed by use of multiple regression and other statistical techniques. The end result is the development of a **market line.** This line shows the relationship between job value, as determined by job evaluation points, and pay survey rates. (Details on these methods can be found in any basic statistics text.)

Market line
The line on a graph showing the relationship between job value, as determined by job evaluation points, and pay survey rates.

DIFFERENT PAY STRUCTURES In organizations there are a number of different job families. The pay survey data may reveal that there are different levels of pay due to market factors, which may lead to firms establishing several different pay structures, rather than just one structure. Examples of some common pay structures are (1) hourly and salaried; (2) office, plant, technical, professional, and managerial; and (3) clerical, information technology, professional, supervisory, management, and executive.

One basis for determining how many and which pay structures to have is the nature and culture of the organization. Another basis is the results of the statistical analysis done when determining market lines, particularly the r^2 levels when the data is analyzed by different job families and groups. Generally, an r^2 of $+.85$ or higher is desired.

ESTABLISHING PAY GRADES In the process of establishing a pay structure, organizations use **pay grades** to group individual jobs having approximately the

Pay grade
A grouping of individual jobs having approximately the same job worth.

FIGURE 13–13 *Establishing Pay Structures*
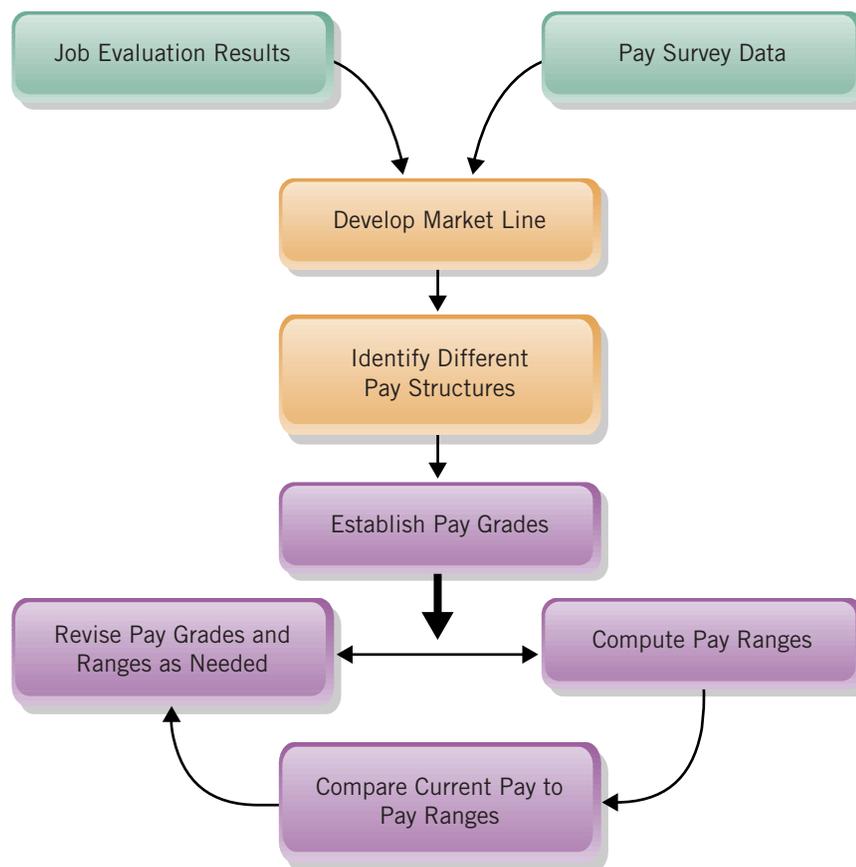
same job worth. While there are no set rules to be used in establishing pay grades, some overall suggestions have been made. Generally, from 11 to 17 grades are used in small companies. However, as discussed earlier, a growing number of employers are reducing the number of grades by *broadbanding*.

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

PAY RANGES The pay range for each pay grade also must be established. Using the market line as a starting point, the employer can determine maximum and minimum pay levels for each pay grade by making the market line the midpoint line of the new pay structure. (See Figure 13–14.) For example, in a particular pay grade, the maximum value may be 20% above the midpoint and the minimum value 20% below it.

FIGURE 13–14 *Pay Scattergram*
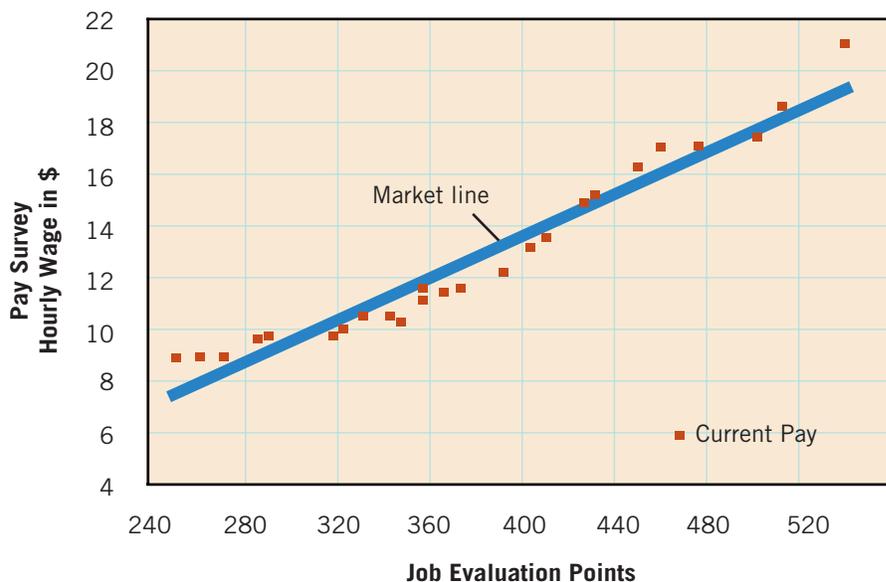
As Figure 13–15 shows, a smaller minimum-to-maximum range should be used for lower-level jobs than for higher-level jobs, primarily because employees in lower-level jobs tend to stay in them for shorter periods of time and have greater promotion possibilities. For example, a clerk-typist might advance to the position of secretary or word processing operator. In contrast, a design engineer likely would have fewer possibilities for upward movement in an organization. This "expanding" approach also recognizes that individual performance can vary more greatly among people in upper-level jobs than in lower-level jobs. However, using the same percentage range at all levels can make administration of a pay system easier in small firms. If broadbanding is used, then much wider ranges, often exceeding 100%, may be used.

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

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

FIGURE 13–15 *Typical Pay Range Widths*

Types of Jobs	Range Above Minimum	% Around Midpoint
Executives	50%–70%	± 20–25%
Mid Management/Professionals	40%–50%	± 16–20%
Technicians/Skilled Craft & Clerical	30%–40%	± 13–16%
General Clerical/Others	25%–35%	± 11–15%

FIGURE 13–16 *Example of Pay Grades and Pay Ranges*
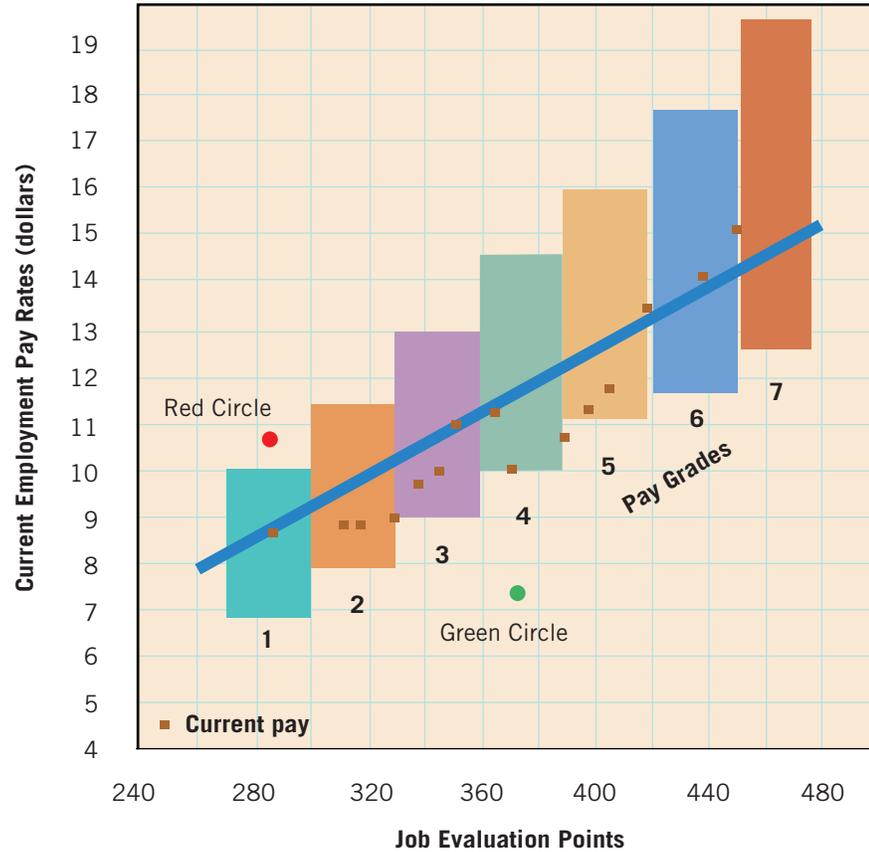
Grade	Point Range	Minimum Pay	Midpoint Pay	Maximum Pay
1	Below 300	6.94	8.50	10.06
2	300–329	7.96	9.75	11.54
3	330–359	8.98	11.00	13.02
4	360–389	10.00	12.25	14.50
5	390–419	11.01	13.49	15.97
6	420–449	11.79	14.74	17.69
7	Over 450	12.79	15.99	19.18

to see the financial input of the new pay structures, then pay policy decisions about market positioning may have to be revised. As a result, changes to the pay ranges may lead to lowering or raising the ranges.

Individual Pay

Once managers have determined pay ranges, they can set the specific pay for individuals. Each dot on the graph in Figure 13–16 represents an individual

employee's current pay in relation to the pay ranges that have been developed. Setting a range for each pay grade gives flexibility by allowing individuals to progress within a grade instead of having to be moved to a new grade each time they receive a raise. A pay range also allows managers to reward the better-performing employees while maintaining the integrity of the pay system.

Rates Out of Range

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

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

Red-circled employee
An incumbent who is paid above the range set for the job.

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

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

Green-circled employee
An incumbent who is paid below the range set for the job.

Pay Compression

One major problem many employers face is **pay compression,** which occurs when the range of pay differences among individuals with different levels of experience and performance becomes small. Pay compression occurs for a number of reasons, but the major one involves the situation in which labor market pay levels increase more rapidly than an employee's pay adjustments. Such situations

Pay compression
Situation in which pay differences among individuals with different levels of experience and performance in the organization becomes small.

have become prevalent in many occupational areas, particularly those in the information technology field.[28]

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

Pay Increases

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

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

Compa-ratio

Pay level divided by the midpoint of the pay range.

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

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

Such charts reflect a person's upward movement in an organization. Upward movement depends on the person's performance, as rated in an appraisal, and on the person's position in the pay range, which has some relation to experience as well. A person's placement on the chart determines what pay raise the person should receive. For example, if employee J is rated as exceeding expectations (3) with a compa-ratio of 89, that person is eligible for a raise of 7% to 9% according to the chart in Figure 13–17.
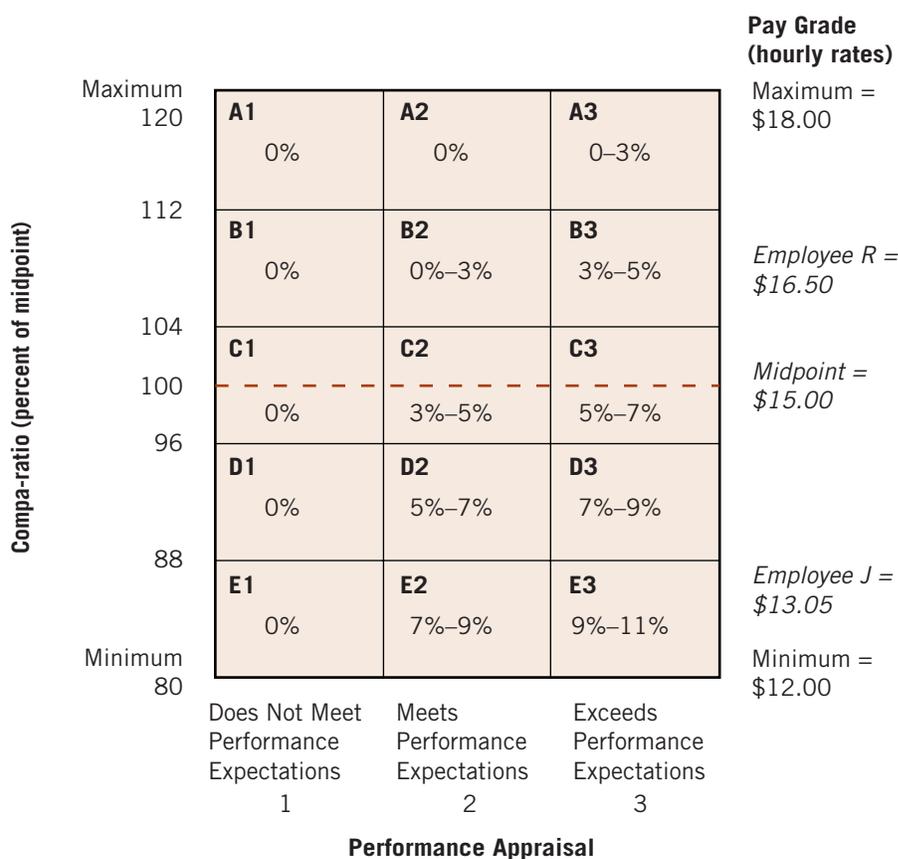
The sample matrix has several interesting facets that illustrate the emphasis on paying for performance. First, those individuals whose performance is below expectations receive no raises, not even a so-called cost-of-living raise. This ap-

proach sends a very strong signal that poor performers will not continue to receive increases just by completing another year of service.

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

In many organizations, pay-for-performance systems are becoming a popular way to change the way pay increases are distributed. In a truly performance-oriented system, no pay raises are given except for increases in performance. Giving pay increases to people because they have 10 to 15 years' experience, even though they are mediocre employees, defeats the approach. Further, unless the performance-based portion of a pay increase is fairly significant, employees may feel it is not worth the extra effort.[29] Giving an outstanding industrial designer making $40,000 a year the "standard raise" of 4% plus 1% for merit means only $400 for merit versus $1,600 for "hanging around another year."

FIGURE 13–17 *Pay Adjustment Matrix*

Compa-ratio (percent of midpoint)	Does Not Meet Performance Expectations 1	Meets Performance Expectations 2	Exceeds Performance Expectations 3	Pay Grade (hourly rates)
Maximum 120	**A1** 0%	**A2** 0%	**A3** 0–3%	Maximum = $18.00
112	**B1** 0%	**B2** 0%–3%	**B3** 3%–5%	Employee R = $16.50
104 / 100 / 96	**C1** 0%	**C2** 3%–5%	**C3** 5%–7%	Midpoint = $15.00
	D1 0%	**D2** 5%–7%	**D3** 7%–9%	
88	**E1** 0%	**E2** 7%–9%	**E3** 9%–11%	Employee J = $13.05
Minimum 80				Minimum = $12.00

Performance Appraisal

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

BNA:
General Increases
Different methods of determining general pay increases, including the cost-of-living approach and others, are discussed at 2225.10.

Lump-sum increase (LSI)
A one-time payment of all or part of a yearly pay increase.

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

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

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

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

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

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

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

ity in their spending patterns so that they can buy big-ticket items without having to take out a loan. In addition, the firm can slow down the increase of base pay, so that the compounding effect of succeeding raises is reduced. Unionized employers, such as Boeing and Ford, have negotiated LSI plans as a way to hold down base wages, which also holds down the rates paid for over-time work. Pension costs and some other benefits, often tied to base wages, can be reduced as well.

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

Summary

- Compensation provided by an organization can come both directly through base pay and variable pay, and indirectly through benefits.
- Compensation responsibilities of both HR specialists and managers must be performed well. Compensation practices are closely related to organizational culture, philosophies, strategies, and objectives.
- A continuum of compensation philosophies exists, ranging from an entitlement-oriented philosophy to a performance-oriented philosophy.
- Compensation strategies are shifting, and organizations must balance cost-effectiveness with labor market realities.
- Competency-based pay that focuses on what capabilities people have is growing in usage.
- Broadbanding, which uses fewer pay grades with wider ranges, provides greater career movement possibilities for employees.
- Variable-pay programs, including those that are team based, are being used to enhance organizational performance and reward greater employee participation in work teams.
- When designing and administering compensation programs, behavioral aspects must be considered. Equity, organizational justice, pay openness, and external equity are all important.
- The Fair Labor Standards Act (FLSA), as amended, is the major federal law that affects pay systems. It requires most organizations to pay a minimum wage and to comply with overtime provisions,

- including appropriately classifying employees as exempt or nonexempt and as independent contractors or employees.
- Other laws place restrictions on employers who have federal supply contracts or federal construction contracts, or on those employers who garnish employees' pay.
- Administration of a wage and salary system requires the development of pay policies that incorporate internal and external equity considerations.
- Job evaluation determines the relative worth of jobs. Several different evaluation methods exist, with the point method being the most widely used.
- Once the job evaluation process has been completed, pay survey data must be collected and a pay structure developed. An effective pay system requires that changes continue to be made as needed.
- Developing a pay structure includes grouping jobs into pay grades and establishing a pay range for each grade. Broadbanding, which uses fewer pay grades with broader ranges, is growing in popularity.
- Individual pay must take into account employees' placement within pay grades. Problems involving rates above or below range and pay compression must be addressed.
- Individual pay increases can be based on performance, cost-of-living adjustments, seniority, or a combination of approaches.

Review and Discussion Questions

1. Give examples of direct and indirect compensation at a recent job that you have had.
2. Discuss what compensation philosophies seemed to be used at organizations where you have worked. What were the consequences of those philosophies?
3. Why are competency-based compensation, broadbanding, and variable pay all related to changing strategies for compensating employees?
4. Discuss the following statement: "If employees believe that subjectivity and favoritism shape the pay system in an organization, then it does not matter that the system was properly designed and implemented."
5. What factors should be considered to determine if an employee who works over 40 hours in a week is due overtime under the FLSA?
6. Considering all methods, why is the point method the most widely used for job evaluation?
7. You have been named compensation manager for a hospital. How would you establish a pay system?
8. Why are pay-for-performance systems growing in importance?

Terms to Know

base pay   416
benchmark job   437
benefit   417
broadbanding   423
compa-ratio   448
compensable factor   438
compensatory time off   431
distributive justice   426
equity   426
exempt employees   430

garnishment   434
green-circled employee   447
job evaluation   437
lump-sum increase (LSI)   450
market line   443
market price   435
maturity curve   450
nonexempt employees   430
pay compression   447
pay equity   433

pay grade   443
pay survey   441
procedural justice   426
red-circled employee   447
salaries   416
variable pay   417
wage and salary administration   434
wages   416

Using the Internet

Using Pay Survey Data

As an HR manager, you are responsible for recruiting top job applicants. Your firm has just lost several administrative and marketing employees to other organizations. To prepare for the hiring process, you need to research market pay data to ensure that your firm is offering a competitive salary to top applicants.

Using the web site at **http://www.ioma.com**, access IOMA's Salary of the month and identify the base pay and average bonus information for administrative and marketing jobs.

The information in the survey is according to Gross Annual Fee Range. Assume the fee range for your firm is "More than $6 Million." The jobs are:

Administrative
- Secretary/Administrative Assistant
- Word Processor
- Receptionist

Marketing
- Marketing Director
- Network Administrator
- Computer Operator

CASE

Implementing a New Compensation Program

The changing nature of jobs in organizations has led to companies redesigning their compensation programs to reflect the changes. As mentioned in the chapter, one approach being used by some employers is competency-based pay. One firm has had success with using a knowledge-based program to measure and reward employees.

This medium-sized manufacturing firm has about 5,000 employees in one location, and none are represented by unions. As a result of continuing efforts by the firm's management to examine and apply innovative organization and management practices, the senior managers at the company decided to redesign work processes and compensation in three production departments. A task force of employees analyzed the work in each of the production departments and recommended some changes.

First, individual jobs and job descriptions were changed to using a team-work approach. In the new system, workers were expected to become skilled in several tasks and rotate throughout the different tasks, depending upon the production schedule and workflow. Workers also were expected to perform their own quality control. Finally a pay-for-performance program was developed to encourage workers to broaden their capabilities and to reward them as they did so.

A series of "skill blocks" was identified by HR specialists and others familiar with the jobs, with each skill block containing what a worker was required to know and do. Skill blocks were developed for all processes in the production departments. As employees mastered a skill block, they received pay increases of 20 cents per hour, except for the basic skill block mastery, which provided a 30-cent-per-

hour increase. Because pay is based on the number of skill blocks mastered, no maximum pay levels were set. These increases were granted on top of the entry-level pay rate of $9.81 per hour.

Following the communication of the new program, employees could choose to convert to the new program or transfer to other departments still using the traditional job-based pay plan. Only one production worker opted to transfer out of the new production compensation program and the department. HR specialists and production mnagers spent considerable time meeting with workers on the processes to be used to assess their competencies. Also, extensive training support had to be implemented so that employees could develop additional mastery of other skill blocks. Other coordination and program administration issues had to be addressed as well.

As a result of the changes to the new program, production technicians are rewarded continually for learning more and enhancing their capabilities. Also, greater workforce flexibility has resulted, so that workers can move between jobs and tasks as production needs dictate. Productivity has increased and production employees have become more knowledgeable about the linkage between compensation, their capabilities, and productivity.[30]

Questions

1. Discuss how changing the compensation program was consistent with the strategic shifts occurring in the organization.
2. What difficulties can you identify with shifting to the new compensation program from the traditional ones used in many production settings?

Notes

1. Adapted from Jennifer J. Laabs, "Rating Jobs Against New Values," *Workforce,* May 1997, 38–49.
2. Eamon Cassidy and Carol Ackah, "A Role for Reward in Organizational Change?" *IBAR* 18 (1997), 52–62.
3. Howard Risher, "The Search for a New Model for Salary Management: Is There Support for Private Sector Practices?" *Public Personnel Management,* Winter 1997, 431–439.
4. Adapted from Brian Murphy and Barry Gebhart, "An Empirical Analysis of a Skill-Based Pay Program and Plant Performance Outcomes," *Academy of Management Journal* 41 (1998) 68–78.
5. "The State of Competencies: ACA's Research One Year Later," *ACA Journal,* Autumn 1997, 54–61.

6. Duncan Brown and Michael Armstrong, "Terms of Enrichment," *People Management,* September 11, 1997, 36–38.

7. Kenan S. Abosch and Beverly L. Hmurovic, "A Traveler's Guide to Broadbanding," *ACA Journal,* Summer 1998, 38–47.

8. Kathryn Tyler, "Compensation Strategies Can Foster Lateral Moves and Growing in Place," *HR Magazine,* April 1998, 64–71.

9. Barbara Parus, "Broadbanding Highly Effective, Survey Shows," *ACA News,* July/August 1998, 40–42.

10. Christian M. Ellis and Jeff McCutheon, "Critical Success Factors for Implementing Banding in Complex Organizations," *ACA News*, February 1999, 30–32; and Neil Merrick, "Broadbanding Not a 'Quick Fix'," *People Management,* February 20, 1997, 16.

11. Adapted from C. James Novak, "Proceed with Caution when Paying Teams," *HR Magazine,* April 1997, 73–78.

12. Jacquelyn S. DeMatteo, et al., "Factors Related to the Successful Implementation of Team-Based Rewards," *ACA Journal,* Winter 1997, 16–27.

13. Patricia K. Zingheim and Jay R. Schuster, "Best Practices for Small-Team Pay," *ACA Journal,* Spring 1997, 40–49.

14. Anthony T. Cobb, Mike Vest, and Fred Hills, "Who Delivers Justice?: Source Perceptions of Procedural Fairness," *Journal of Applied Social Psychology* 27 (1997), 1021–1040.

15. For more specifics, see *Handy Reference Guide to the Fair Labor Standard Act,* WH Publication no. 1282 (Washington, DC: U.S. Department of Labor, Employment Standards Administration, Wage and Hour Division).

16. "New Demands for a Higher Minimum Wage," *Compensation & Benefits Review,* March/April 1998, 22–23; "City by City, Employers Forced to Pay 'Living Wage'," *Bulletin to Management,* October 30, 1997, 345; Tim Harcourt, "The Economics of the Living Wage," *Australian Economic Review,* June 1997, 194–203; and William Van Lear, "Reflections on the Minimum Wage," *Journal of Economic Issues,* 31 (1997), 263–265.

17. For more details see J. E. Kalet, *Primer on FLSA and Other Wage and Hour Laws,* 3rd ed. (Washington, DC: Bureau of National Affairs, 1994).

18. Michael N. Wolfe, "Classification of Workers: Independent Contractor vs. Employee," *ACA Journal,* Summer 1998, 6–15.

19. Deborah Shalowitz Cowans, "Equal Pay Ranks First for Women," *Business Insurance,* September 15, 1997, 71.

20. "Job Evaluation Products," Organisatieadvies Worst, http://www1.tip.nl/~t169028/homepag3.htm.

21. Anne Woodsworth, "Putting Our Salaries Where Our Jobs Are," *Library Journal,* January 1997, 61.

22. For a detailed discussion of the Hay system, see Richard I. Henderson, *Compensation Management in a Knowledge-Based World,* 7th ed. (Englewood Cliffs, NJ: Prentice-Hall, 1997), 277–294.

23. Adapted from Fay Hansen, "Guide to Salary Survey Data on the Web," *Compensation & Benefits Review,* March/April 1998, 16–20.

24. Michael O'Malley, "Testing for Gender Differences on Pay," *ACA Journal,* Summer 1998, 6–15.

25. Joyce A. Cain, et al., "The Future of Salary Surveys," *ACA News,* October 1997, 32–36.

26. John Yurkat, "Is 'The End of Jobs' the End of Pay Surveys Too?" *Compensation & Benefits Review,* July/August 1997, 24+.

27. *District of Utah, U.S. District Court v. Utah Society for Healthcare Human Resources Administration, et al. Federal Register,* March 1994, 14203.

28. Marilyn Moats Kennedy, "Are you A Victim of 'Salary Compression'?" *Manager's Intelligence Report,* 1998, www.ragan.com.

29. Atul Mitra, Nina Gupta, and G. Douglas Jenkins, "A Drop in the Bucket: When Is a Pay Raise a Pay Raise?" *Journal of Organizational Behavior* 18 (1997), 117–137.

30. Adapted from Gerald D. Klein, "Case Study: A Pay-for-Knowledge Compensation Program That Works," *Compensation & Benefits Review,* March 1998, 69–75.