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Competitive Pay Policy

Lena M. Bottos and Christopher J. Fusco, SPHR
Salary.com, Inc.

Abstract
A competitive pay policy articulates an organization's strategy for competing within targeted labor markets to recruit the employees it needs to achieve business success. Such policy guides managers in making effective decisions regarding the company's investment in human capital assets. How a company articulates its competitive pay policy, therefore, is instrumental to optimizing pay program effectiveness.

An effective pay policy is an important aspect of a company's overall competitive strategy. Just as organizations compete to sell their products and services, they also compete with one another for talented employees. Toward that end, a competitive pay policy is the cornerstone of an organization's human capital investment strategy.

How a company competes depends on three recruiting market conditions:

- The extent to which qualified employees are available in targeted recruiting markets.
- The aggressiveness of other employers competing within those same recruiting markets.
- The company's clout in the marketplace to recruit qualified employees (e.g., financial resources to pay employees, perception of the company as an employer of choice, etc.).

A competitive pay policy addresses these three market conditions. It articulates the company's strategic position for competing within its recruiting markets in terms of the pay elements it will offer employees and the pay levels it will target for each element. The policy sets forth the principles that guide design, implementation, and administration of the company's compensation program.[1]

Attract, Retain, And Productively Employ the Human Capital Assets of the Company Using a Total Rewards Model

WorldatWork defines the total rewards model as "all of the tools available to the employer that may be used to attract, retain, and motivate employees." The elements of the total rewards model include:

- Compensation–cash paid by an employer to its employees for services rendered.
- Benefits–health, welfare, income protection, and capital accumulation programs provided by an employer that supplement cash compensation.
- Working conditions–reward elements that are important to employees, but less tangible than compensation and benefits (e.g., performance recognition, work-life balance, developmental opportunities, company culture, etc.)

In designing a competitive pay policy, a company considers the relative emphasis of these three total rewards components to build its human capital investment strategy. If, for example, the organization emphasized compensation, it would position itself to compete for talent by offering employees base salaries and incentive payments that meet or exceed cash compensation levels offered by the competition. As an offset to placing greater emphasis on cash compensation, the company might offer benefits that are less favorable than those of competitors. Although one element of the total rewards model may be emphasized, decisions must be made with regard to the company's competitive stance on all three elements. Emphasis on one element versus another is a strategic decision based on company requirements to recruit needed employees. In the right combination, these elements can be used to craft a system for administering pay that helps accomplish the company's strategic objectives.

Competitive Policy Expressed in Terms of Market Pay Level

The competitive policy is typically expressed in terms of percentile levels of targeted market pay. The most prevalent competitive pay policy, for example, is the market 50th percentile (median).[2] Employers with a median competitive pay policy are choosing neither to lead nor follow within their recruiting markets. Other employers choose a competitive pay policy above or below the median level to compete more or less aggressively, respectively, within their recruiting markets. A market median pay policy typically applies to both the base salary and benefits package provided by a company, although the level at which a company competes can be different for these elements. For example, many companies that offer bonuses or incentives target a market percentile level for total cash compensation (base pay plus paid bonuses) that is greater than that for base salary alone. Some companies might favor pay that is structured to attract employees (e.g., short-term incentives) over pay that helps retain them (e.g., long-term incentives). But few

companies can afford to attract, motivate, and retain via compensation and benefits at the expense of not providing a quality working environment. The challenge is to create a pay policy that leverages all three elements without exhausting the company's limited resources.

Figure 1 exhibits prototypical pay policies for four hypothetical organizations at various stages of the business cycle. The organizations are a cash-poor startup business; a growing business with limited capitalization; a mature, well capitalized organization; and a declining business. These prototypes do not account for the myriad strategic and operational realities faced by different types of organizations. For example, the amount of capital available to an organization varies dramatically, and with it, the ability to hire aggressively or pay competitively.

Competing For Employees Within Recruiting Markets

Companies hire employees from, and lose employees to, various recruiting markets. A recruiting market is the segment of the national labor market from which a company hires its employees. To define recruiting markets, an organization should identify the relevant industries, company sizes, and geographies that represent the employers with which it competes for talented employees. Different jobs may be benchmarked against different groups of competing employers depending on the recruiting market and role a particular job or class of jobs fills in the organization. Therefore, the job being evaluated is the one to consider to define the relevant recruiting market. For example, compensation for executive jobs tends to vary according to industry and company size as opposed to geography. Geography, however, is often the primary influence of compensation levels for many lower-paid jobs.

Analyzing Pay Practices Within Recruiting Markets to Assess Competitive Standing

Compensation professionals identify the market range of pay for a company job by analyzing available survey data for the specified recruiting market. Further analysis predicts the market value necessary for the employer to attract and retain employees with the desired qualifications of the job. A company uses such analysis to arrive at its competitive pay policy and to assess its competitive standing. Competitive standing is a measure of an employer's compensation levels compared to those employers within its recruiting market. As a fairness criterion, competitiveness (external equity) implies that the employer compensates employees at levels that correspond to prevailing external market rates.[3]

Figure 1: Prototypical Pay Policies for Four Hypothetical Organizations at Various Stages of the Business Cycle

Company Type – Business Cycle	Base Pay (cash)	Annual Incentives (cash)	Long-Term Incentives (stock)	Nonfinancial Rewards (benefits, culture)
Startup – Scarcity of cash means long-term incentives are emphasized.	Targeted at market 25th percentile for the relevant recruiting markets.	Offered only to employees engaged in revenue-generating activities such as sales.	Targeted at the market 75th percentile for the relevant recruiting markets.	Benefits targeted below market median. Culture of innovation and hard work with high levels of accountability for all employees.
Growth – Positive cash flows used primarily for reinvestment; long-term incentives still important, but cash is available for some annual incentives.	Targeted between market 25th percentile and median for the relevant recruiting markets.	Offered more broadly to employees engaged in the fulfillment of key business operations such as product development, sales, and service.	Targeted between market median and 75th percentile for the relevant recruiting markets.	Benefits targeted at market median levels. Culture of striving toward stretch goals and celebration of accomplishments.
Mature – Producing lots of cash; base pay and annual incentives emphasized.	Targeted at market median for the relevant recruiting markets.	Offered broadly to employees to emphasize short-term business objectives.	Reserved for executives and "high-potential" employees. Targeted at market median for the relevant recruiting markets.	Benefits targeted at market median levels. Culture of performance management to maintain the state of the business.
Declining – Salaries still be emphasized at early stages of decline; various scenarios possible if turnaround isn't achieved.	Targeted at market median for the relevant recruiting markets.	Depends on the availability of positive cash flows.	May be offered to retain key employees needed to execute a turnaround strategy.	Benefits may be reduced to levels below market median to conserve cash. Culture characterized by organizational change.

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Review Employee Pay Annually to Calibrate Company Pay Practices with Competitive Pay Levels

Companies typically review employees' pay and performance once each year, but market pay levels move continuously. Market pay levels typically increase over time because competing employers deliver salary raises to reward the performance of employees and to maintain the competitiveness of their pay levels.

To maintain competitiveness, companies must decide their policy for reviewing their pay practices, and whether to lead the market at the beginning of the year and lag behind at the end of the year; or to lag behind at the beginning of the year and lead at the end. These two pay calibration approaches are called "lead-lag" and "lag-lead," respectively.

Before reviewing pay for the employee, review the competitive pay levels for the job. Many jobs are subject to change over time, due to internal and external factors including technology advances, industry changes, employers' needs, and incumbents' capabilities. Therefore, reevaluate the job once a year and, if appropriate, select a new benchmark job and recruiting market.

Balance the Market Range of Pay with an Employee's Market Value

A competitive pay policy contains guidelines for the administration of the company's pay programs. Such guidelines specify criteria for maintaining both internal and external pay equity among employees. Therefore, a company's pay policy could specify the criteria to be used by managers for placing an employee's pay appropriately within the relevant market range of pay based on the value of the employee's capabilities. Employees that demonstrate the criteria for "successful" performance of the job would have their pay placed at the targeted market level for that job.

Conversely, some companies have a pay policy that starts all new employees at the minimum of the pay range. While this may be appropriate for inexperienced candidates, it is inappropriate for experienced candidates. Paying at the minimum for all new employees will likely create recruiting problems, since the minimum is generally below market value for experienced people. In addition, the practice of hiring all employees at the pay range minimum will cause pay compression over time.[4]

The recommended approach is to establish pay practices that reflect employees' capabilities. When using this approach, an employee's skills and competencies are evaluated through the interviewing process for new employees or through the annual performance evaluation process for current employees. The pay level would be determined with respect to the company's competitive pay policy, the administrative guidelines of the pay policy covering employee capabilities, internal equity, and budget constraints. This process results in employee pay being set at an appropriate value within the market range.

Assess the Competitiveness of Employee Pay

The formula commonly used by compensation professionals to assess the competitiveness of an employee's pay level involves calculating a "comparatio." Comparatio is the employee's current salary divided by the current market rate as defined by the company's competitive pay policy. For example, if an employee earns $45,000 and the market median pay level for that job is $50,000, the employee has a comparatio of 90%.

A company's salary range midpoint, which serves as a proxy for the targeted market rate, can be used as an alternative denominator in the comparatio equation.

A talented employee whose pay has lingered at a comparatio of 90% is at risk of seeking employment with competitors at a higher pay level that is perceived to be more equitable. The company interested in retaining this employee would consider raising the employee's pay level closer to the market median pay level.

If the company doesn't want to pay 100% of market for this job, for example if the employee is not fully proficient in the job, it might still make sense to pay the employee at 95% of market. In this scenario, the company might be willing to raise the employee's pay by $2,500 to insure against the greater cost of hiring a new employee.

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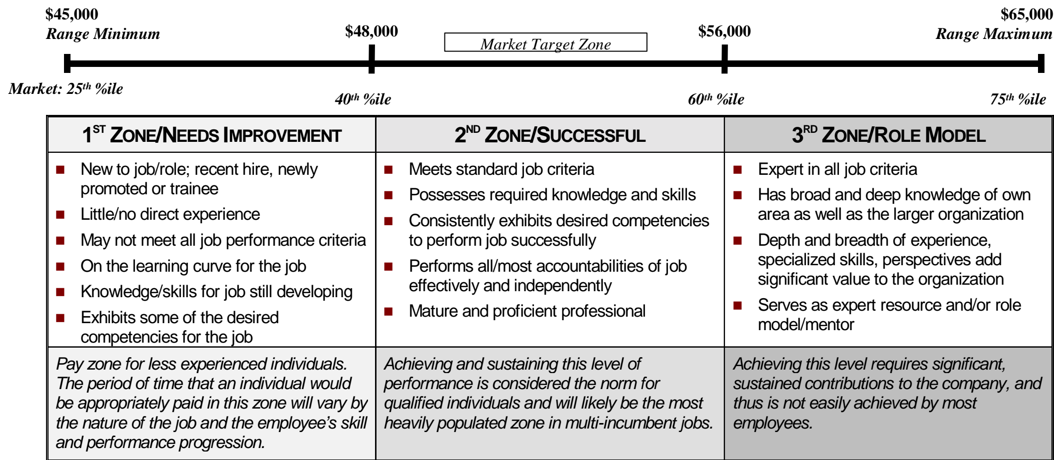
Develop Pay Administration Guidelines

Figure 2 shows how the market pay range for a job can be defined with administrative guidelines, as appropriate for the given job or class of jobs, for the proper placement of employee pay within the range. Assume for the illustration shown in Figure 2 that the company's competitive strategy is to target the market median pay level, which has a value of $52,000. The employer in this example may recruit the candidate who demonstrated the qualifications to be successful in the job by executing a decision to offer a starting salary that falls within the second zone of the range, perhaps $49,000, which results in a comparatio of 94%. Moreover, employers would also use such guidelines to place individuals' pay appropriately within the range over time to maintain internal and external equity.

Figure 2: Sample Administration Guidelines for Placing Employee Pay Within the Job's Market Range



1ST ZONE/NEEDS IMPROVEMENT	2ND ZONE/SUCCESSFUL	3RD ZONE/ROLE MODEL
■ New to job/role; recent hire, newly promoted or trainee ■ Little/no direct experience ■ May not meet all job performance criteria ■ On the learning curve for the job ■ Knowledge/skills for job still developing ■ Exhibits some of the desired competencies for the job	■ Meets standard job criteria ■ Possesses required knowledge and skills ■ Consistently exhibits desired competencies to perform job successfully ■ Performs all/most accountabilities of job effectively and independently ■ Mature and proficient professional	■ Expert in all job criteria ■ Has broad and deep knowledge of own area as well as the larger organization ■ Depth and breadth of experience, specialized skills, perspectives add significant value to the organization ■ Serves as expert resource and/or role model/mentor
Pay zone for less experienced individuals. The period of time that an individual would be appropriately paid in this zone will vary by the nature of the job and the employee's skill and performance progression.	*Achieving and sustaining this level of performance is considered the norm for qualified individuals and will likely be the most heavily populated zone in multi-incumbent jobs.*	*Achieving this level requires significant, sustained contributions to the company, and thus is not easily achieved by most employees.*

Considerations For Performance Management

Employee capability is not the same thing as performance. Someone who is not yet successful in fulfilling the job may still be learning some of the basic skills, especially after a promotion. Yet the employee's performance may exceed the manager's expectations. Poor performers fall short of fulfilling the manager's expectations for successful performance of the job, and companies do not typically retain such employees.

As employees become successful in fulfilling their job, it is important to place their pay into the "market target zone." Otherwise their pay will stagnate and they may become unmotivated or seek employment from competitors for recognition and rewards.

Administer Pay Programs Consistently

By law, pay practices may not discriminate; they must be administered consistently, not arbitrarily. Yet pay policy must be designed with flexibility to recognize and reward employees at various stages of development, or employees who fulfill key jobs.

For example, a company might decide to pay a market median rate for most jobs and an aggressive rate for jobs that are especially difficult to fill and important to achieving business success. Such a company may determine the necessity to pay its "hot skills" jobs at the 75th percentile and the rest of its employees at the 50th percentile.[5]

Legal rulings regarding discrimination often center on the principle that it is more egregious to violate and be inconsistent with your own pay policy than it is to be noncompliant with the law.

Communication Is Part of Retention

An employer benefits from communicating with employees about their pay policies. An employee benefits by understanding how pay is determined, because a sound policy that is consistently administered creates a sense of fairness. Lack of communication tends to breed skepticism among employees in the belief that they are paid fairly.

Develop a finely honed message, which can be communicated consistently and frequently, regarding the business reasons for adopting a particular pay policy. Pay policy supports retention when employees understand that the employer is making a concerted effort to deliver pay that is fair and equitable.

Competitive Pay Policy Requires the Involvement of Company Leadership

Pay policies are just as important for startups as they are for established companies, because without them companies risk underpaying or overpaying their employees. When a company develops a new pay policy, company leadership ensures alignment with company objectives and assumes ownership for effective implementation.

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Notes

1 The term "policy" as used in this white paper establishes the strategic and philosophical principles that guide design, implementation, and administration of an employer's compensation programs. Compensation strategy supports an organization's business objectives and specifies what programs will be used and how they will be administered. Compensation philosophy ensures that compensation programs support an organization's culture.

2 The market 50th percentile (median) pay level is the value at which 50% of an employer sample pays less and 50% pays more.

3 External equity must be balanced with "internal equity." Internal equity is a fairness criterion that implies an employer's pay practices correspond to each job's relative value in the organization.

4 "Pay compression" occurs when the pay rates of several employees, despite clear differences in capability, are clustered. This means that highly capable employees are paid similarly to employees with less skill and experience. This eventually creates morale problems, particularly for the more capable employees.

5 "Hot skills" jobs require employees with skills that are in short supply and high demand. Recruiting markets for hot skills jobs undergo a rapid escalation in market pay value.

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