Educating and Inspiring the World at Work NOVEMBER/DECEMBER 2019
WORKSPAN

The Promised Land

The Optimal Pay Structure for 2020

By Brad Hill

The optimal pay structure for 2020 will allow companies to effectively manage their payroll costs, while providing employees with a meaningful understanding of their pay and career opportunities.

To develop the optimal pay structure, we should first review the primary components of that structure:

1. **Pay grades:** The number of pay gradations necessary for the organization to capture the range of job value from lowest to highest, while effectively communicating job hierarchy and career progression.
2. **Pay ranges:** The pay opportunity within each pay grade from the lowest pay level (the hiring rate) to the highest pay level (for long-term outstanding performers).
3. **Number of pay structures:** The number of pay structures needed to effectively compete in different locations, different business units/subsidiaries and different functions.

The Promised Land

Worthy of note is the rapidly advancing minimum wage in some cities/states — which can dramatically outpace pay and pay structures — and its impact on the lower pay grades.

Let's look at some of the problems with our current pay structures and what can be done to improve them in 2020.

Optimal Number of Pay Grades

The Problem

The problem with the number of pay grades at many organizations started in the late 1980s with the broadbanding craze. Jobs with very different values were being clustered into the same pay grade/level in the name of simplicity. This act gave managers the flexibility that they craved, but it took the science out of determining the value of a job and blurred the lines between job value and employee value. The result was fewer pay grades and fewer ways to effectively determine, administer and control payroll. Pay grades are an important way to communicate job value, hierarchy and career progression, and with too few grades all of these important communications are weakened. While there may be good reasons to have lots of pay grades (the illusion of frequent progression/promotions) or fewer pay grades (more flexibility with pay), if pay grades are to help the organization discern meaningful differences in the value of its jobs, there is a "most ideal" number of pay grades for the organization. At a minimum, this should be the starting point for the discussion on how many pay grades the organization should have.

The Solution

The proper number of pay grades will depend on the range of expected contribution from the lowest- to highest-level job. Research in the 1950s conducted by the Hay Group (and its application of Weber's Law regarding the "just noticeable difference" between two items) found that when experts compare two jobs, there must be at least a 15% difference in perceived job value in order to determine that one job is larger than another. Today, we find that this basic tenet continues to be applied — knowingly or unknowingly — as the majority of organizations have a 10% to 19% midpoint progression for both hourly and salaried employees, according to WorldatWork and Willis Towers Watson's survey, "Compensation Programs and Practices 2019." So, the optimal number of pay grades is roughly calculated by taking the lowest midpoint and moving in 15% increments until the CEO midpoint is reached. Note that the midpoint of the CEO may actually be two or three pay grades higher than the No. 2 position, which the organization may choose not to recognize.

Another item worthy of note is the rapidly advancing minimum wage in some cities/states — which can dramatically outpace pay and pay structure increases — and its impact on the lower pay grades. Typically, the minimum wage establishes the pay range minimum for the lowest pay grade. This should continue to be the case. However, the midpoint progressions for the lower grades may have to be reduced to prevent the minimum wage increase from cascading up to the top of the organization. For example, instead of a 15% midpoint progression for the first three grades, we may choose to progress at a much lower rate (say, 7.5%) to keep the cost increase spawned by the higher minimum wage contained to the first three grades. The minimum wage increase will benefit the lower-level jobs but may force us to ignore the true (15%) internal job-value differences among these jobs in the short term.

Optimal Pay Ranges

The Problem

The logic behind pay ranges is fairly consistent among organizations. Pay ranges are designed to serve as a key cost-control mechanism for the organization by identifying target rates of pay for different levels of expected contribution within a job, thereby removing much of the subjectivity around pay. There are three main components of the pay range.

The **minimum** of the pay range is the rate paid to an employee who is assigned to a job for which they possess minimal qualifications/experience and who is expected to be able to perform the

PHOTO © ISTOCK/GRANDFAILURE

basic duties and responsibilities after normal training. Most organizations set their range minimum, or hiring rate, at 80% of the midpoint, according to the WorldatWork/Willis Towers Watson compensation survey.

The **midpoint** represents the target rate of pay for the job (i.e., the market 50th percentile in the vast majority of organizations). The target rate of pay is associated with an employee who has achieved full competence in the job and is performing at a fully satisfactory level.

The **maximum** of the pay range is the most we would typically want to pay a consistently outstanding performer in the job. Most organizations set their range maximum at 120% of midpoint, according to the WorldatWork/Willis Towers Watson survey.

The concept behind the pay range is that a new employee with minimal qualifications/experience is hired in at the minimum of the range. The employee then receives pay increases each year in an amount that recognizes their growth and development, and when they reach full competence, they will be paid at the midpoint of the range, which is also reflective of the market rate of pay for the job. Over time, outstanding employees who exceed fully satisfactory performance will be allowed to be paid up to 120% of the range midpoint.

Most organizations set their pay range midpoints at the market median (50th percentile), and therefore the midpoints must be adjusted each year to reflect the estimated movement of the market median. This adjustment figure is called the Salary Structure Adjustment and is reported each year in the WorldatWork's annual "Salary Budget Survey." Advancing toward the midpoint of the salary range is advancing toward a moving target. Since 2011, the average pay increase has been 3% a year and the pay structure has been adjusted by 1.9% a year. So, the average employee has progressed 1.1% a year toward the midpoint. While we may expect the average, minimally qualified new hire to become fully competent in their job in two years — or for some challenging positions, maybe five or six years — it may actually take them as long as 20 years to do so. Most organizations do not have the tools to pay midpoint for full competence because their pay increase budgets are too small and their salary ranges are too wide.

Year	Salary Budget Increase (Salaried Employees)	Salary Structure Increases	Annual Range Penetration
2011	2.8%	1.5%	1.3%
2012	2.9%	1.7%	1.2%
2013	2.9%	1.9%	1.0%
2014	3.0%	1.9%	1.1%
2015	3.0%	2.0%	1.0%
2016	3.0%	2.0%	1.0%
2017	3.1%	2.0%	1.1%
2018	3.1%	2.1%	1.0%
2019	3.2%	2.1%	1.1%
Average	3.0%	1.9%	1.1%

Source: WorldatWork. "Salary Budget Survey," 2011-2019.

Being paid at midpoint when full competence is achieved has always been a myth (See "A Different Time."). In reality, an employee will only ever be paid at midpoint if:

1. They are an outstanding employee consistently receiving well-above-market pay increases;
2. They are hired into or promoted into a grade at a rate significantly above minimum; or
3. They have been competent in the same job for 15 to 20 years.

The Solution

In most organizations, the pay ranges are too wide to fulfill the promise of paying most fully competent employees at market. Pay range minimums should be increased to 90% of market, and if the organization is into balanced pay ranges, the pay range maximums can be moved to 110% of market. Or, if the organization would like to allow pay to continue to advance with the learning and growth of employees for many years, the organization may leave the pay range maximums where they are — but they may want to change the word "midpoint" to market or target pay. Finally, if raising pay range minimums is a solution that is too costly to

The Promised Land

A Different Time

Pay ranges have been around a long time, and yet the construct of the salary range (50% salary range widths with a hiring rate at 80% of midpoint/market) hasn't changed much over the years. If we go back to 1977, the 50% pay range was just as popular and would seem to make more sense. Believe it or not, salary increases were averaging 9% to 10% back then, according to WorldatWork's "Salary Budget Survey" data. So, employees would probably be tearing through their range at a much faster rate, right? That was my assumption in putting together this article, that times changed: Inflation fell, salary increase budgets fell and employees' progression through their pay range dramatically slowed, but we never changed our pay structure or our promise that employees would be paid at midpoint, or market, when they became fully competent in their job.

Year	Salary Budget Increase (Salaried Employees)	Salary Structure Increases	Annual Range Penetration
1977	8.3%	7.3%	1.0%
1978	8.4%	7.4%	1.0%
1979	8.1%	7.5%	0.6%
1980	10.0%	8.7%	1.3%
1981	10.5%	9.4%	1.1%
1982	9.1%	7.8%	1.3%
Average	9.1%	8.0%	1.1%

But, in fact, that is not the case. Back when pay increase budgets were at or near double digits, salary structure increases were almost as high. On average, they lagged behind the salary budget increases by exactly the same amount as today. We can only conclude that we have always misled employees when we promised that when they became fully competent, they would be paid at market.

entertain, then the organization should change the employee's expectations regarding advancing through their pay range. Let them know that they can continue to learn, grow and advance through their pay range for many years to come, but they should expect to be promoted before reaching their (moving target) pay range midpoint.

Optimal Number of Pay Structures

The Problem

Organizations must do more to ensure that their pay structures address the need to pay jobs differently based upon geography, business unit/subsidiary or function. According to a recent WorldatWork/Deloitte Consulting survey, "Salary Structure Policies and Practices Survey 2019," a whopping 96% of organizations target their pay range midpoints at the 50th percentile of market, and 41% of organizations have zero or only one pay structure. It is difficult to use pay as an effective tool to attract and retain people if the organization is paying the same as every other organization and is not open to differentiating its pay policy based upon location and function. Let's examine how pay structures can help fine-tune the organization's pay policy across the business.

The Solution

The optimal number of pay structures for an organization is often developed by creating a core structure, then assigning premiums and discounts to the core structure to properly position the organization's pay in its different competitive markets. For example, to hire the right people into IT jobs, the organization may have to pay a 20% premium for jobs in grades 7 through 12. Yet, to hire the right people into warehouse, distribution or customer service jobs, the organization may be able to pay a 10% discount to jobs in grades 2 through 5. Each premium/discount should represent a strategic pay posture designed to maximize the return on investment of the overall organization's payroll.

In creating geographic differentials for a pay structure, it is important to choose whether the organization wants to recognize geographic pay differences or geographic cost-of-living differences. Geographic pay differences reflect the supply and demand of talent in the location, while geographic

It is difficult to use pay as an effective tool to attract and retain people if the organization is paying the same as every other organization and is not open to differentiating its pay policy based upon location and function.

cost-of-living differences reflect the cost of goods and services in the area (such as rent, utilitie and taxes). Although these two factors are usually correlated, sometimes they are strikingly different. For example, Miami Beach wages are about 96% of the national average, while its cost of living is 157% of the national average, based on data reported by the Economic Research Institute. Miami Beach is a very desirable location, so people are willing to accept higher costs and earn less to live there. On the other hand, wages in Flint, Mich., are 100% of the national average, while its cost of living is 85% of the national average.

If the organization is primarily interested in attracting local talent and paying employees competitively, then recognizing geographic pay differences makes sense. If the organization is frequently moving employees from location to location and wants them to maintain a similar standard of living at each location, then recognizing cost-of-living pay structure differences may make the most sense.

One warning we would issue around multiple pay structures is to not place the same job in different grades in different pay structures. The pay grade determination should be based on the expected contribution of the job to the organization, and that shouldn't be different for different markets or functions. In other words, a grade 5 job should always be placed in grade 5, with no exceptions. Paying "hot job" employees above range maximum is a far lesser sin than putting a job into a higher pay grade than is explained by its expected contribution. The latter will likely create pressure for additional upgrades and a loss of the meaning behind pay grades.

Geography, local supply and demand, the presence of labor unions and the specific skills that are needed to succeed in an area may all dictate pay policy differences within the organization. Any increase in administrative cost/burden associated with multiple pay structures will be more than offset by improvements in the organization's return on payroll.

Adding It All Up

There are several activities that may help fulfill the optimal pay structure promise of effectively managing payroll costs, while providing employees with a better understanding of their pay and career opportunities. The following is the recommended course of action for each component of the optimal pay structure.

- **Pay ranges:** Raise the pay range minimums to 90% of midpoint (target) to enable employees to progress to target/midpoint in a reasonable amount of time.
- **Pay grades:** Provide the number of pay grades that most effectively communicates job hierarchy and career progression, ideally with a 15% pay difference from one pay grade to the next.
- **Number of pay structures:** Develop the number of pay structures that best accommodates the organization's geographic, business unit and talent markets. Set the core structure midpoint (target rate) where it provides a competitive business advantage. Think of the pay philosophy of Ken Iverson, founder of Nucor Steel, who stated, "We hire five, work them like 10 and pay them like eight." Remember that employees care more about how they will progress through their range and beyond than how their midpoint is set versus market.

These guidelines are deliberately prescriptive, yet we absolutely recognize the need for each organization to make minor adjustments to the pay range and pay grade guidelines, and to develop a pay structure philosophy that will provide it with a unique competitive advantage. **WS**

Brad Hill, CCP, is a principal at Clearwater Human Capital and has been a WorldatWork member for more than 20 years. He can be reached at *brad.hill@clearwater-hc.com*.