ECONOMIC RESEARCH INSTITUTE

How to Manage Salary Compression Issues

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Now more than ever, a variety of factors are on a collision course impacting an organization's ability to pay its employees fairly and equitably—causing salary compression issues. Minimum wage changes, pay equity laws, FLSA overtime rule changes, stagnant salary increase budgets, mergers and acquisitions, new hire compensation, and supervisor-employee pay relationships are all common contributors to salary compression issues.

Pay compression occurs when the relationship between two or more employees is too small to be equitable. Pay compression may be related to one or more of the following factors:

New Hire Pay	Pay Equity Laws	Salary Structure	Mergers & Acquisitions
Supervisor-Employee Pay Relationships	FLSA Overtime Thresholds	Inconsistent Performance Ratings & Standards	Inconsistent Pay Practices
Minimum Wage	Promotions & Lack of Career Ladders	Low Salary Budgets	Market-Based Pay
Adjustments to Minimum	Out-of-Cycle Increases	Salary Administration	Job Evaluation & Job Description

Salary compression is a serious issue and may lead to increased turnover, productivity problems, dissatisfied employees, lack of engagement, and even potential discrimination and pay equity claims.

New Hire Pay

New hire compression issues will occur when newly hired employees are paid in excess of current employees with similar or greater experience, skills, and responsibilities.

The prevalence of these issues will increase when the labor supply is low in the marketplace, such as in the case of software developers, information security analysts, data scientists, physical therapists, and registered nurses. Recruiters can be an excellent source of information on difficult jobs to fill and challenging new hire pay rates.

Some organizations effectively manage new hire salaries through a policy limiting new hire compensation, for example, at a 1.05 or 1.10 compa ratio. For these job offers in excess of the desired new hire compa ratio, a compensation review as well as department head approval for compa ratios over 1.05 or 1.10 can help minimize compression issues between new hires and existing employees.

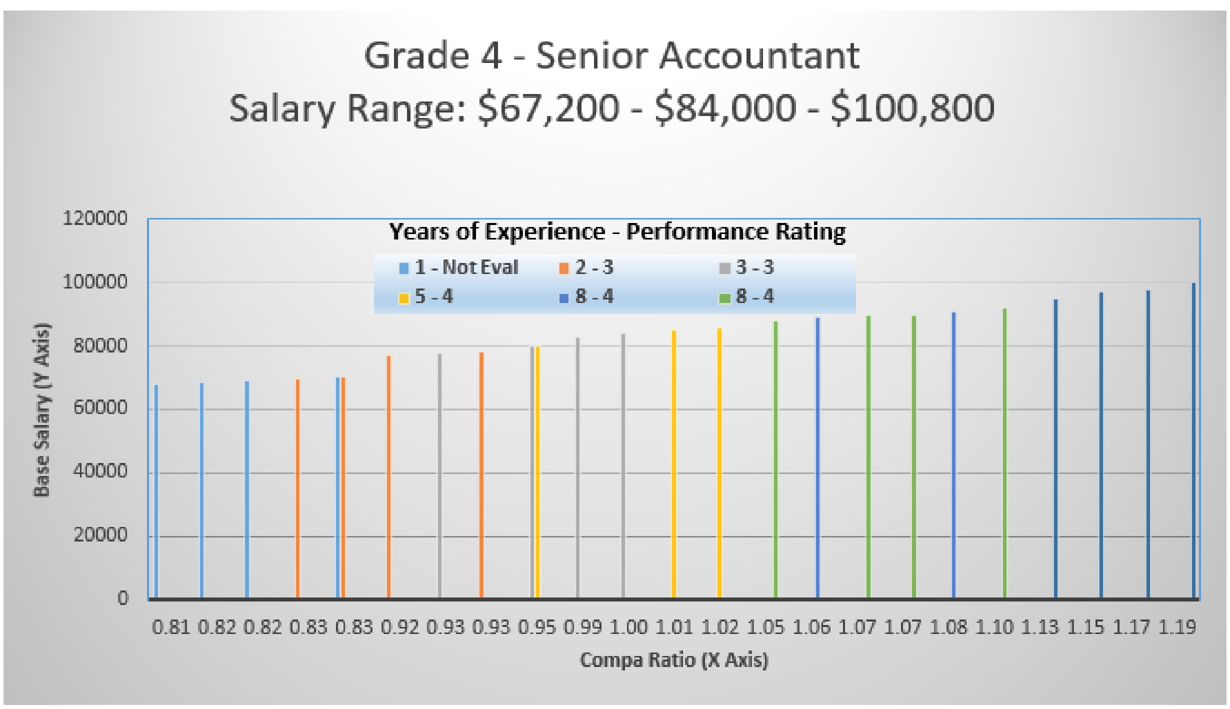
Compensation guidance on new hire compensation will support in ensuring equitable compensation among new hire and existing employees. An internal report reflecting median, average, high, and low compensation by grade, job, and location can assist in minimizing new hire compression issues.

Example - Existing Employee Report - Compa Ratio by Job

Salary Grade	Location	Date of Hire	Date in Position	Perf	Job Title	Dept	Employee Name	Base Salary	Range Min	Range Mid	Range Max	Compa Ratio
4	Seattle, WA	21-Apr-14	21-Apr-14	3	Sr. Accountant	Finance	A Ames	$84,000	$67,200	$84,000	$100,800	1.00
4	Seattle, WA	16-Oct-15	16-Oct-15	3	Sr. Accountant	Finance	B Barnes	$78,500	$67,200	$84,000	$100,800	0.93
4	Seattle, WA	1-Mar-10	1-Mar-10	4	Sr. Accountant	Finance	C Canales	$92,000	$67,200	$84,000	$100,800	1.10
4	Seattle, WA	30-May-12	30-May-12	4	Sr. Accountant	Finance	D Dexter	$86,000	$67,200	$84,000	$100,800	1.02
4	Denver, CO	6-Feb-17	6-Feb-17		Sr. Accountant	Finance	E Eng	$68,500	$67,200	$84,000	$100,800	0.82
4	Denver, CO	15-Mar-10	15-Mar-10	4	Sr. Accountant	Finance	F Franklin	$90,750	$67,200	$84,000	$100,800	1.08
4	Denver, CO	31-Aug-07	31-Aug-07	5	Sr. Accountant	Finance	G Gomez	$98,000	$67,200	$84,000	$100,800	1.17
	Average							$85,393	$67,200	$84,000	$100,800	1.02
	Median							$86,000	$67,200	$84,000	$100,800	1.02
	Low							$68,500	$67,200	$84,000	$100,800	0.82
	High							$98,000	$67,200	$84,000	$100,800	1.17

Another option is to use a pivot chart to reflect key information for a compensation review and to ensure internal equity is managed during the new hire process. Consider the following example:

Example - Existing Employee Pivot Report - Compa Ratio by Job



A ban on salary history inquiries during the hiring process is picking up speed as well. With the increased number of laws at the city and state level, the challenge will be to pay fair and equitable compensation throughout an organization. Once new hire employees are hired over their job worth in the marketplace, additional salary compression issues will likely surface within an organization.

Supervisor-Employee Pay Relationships

An important cause of pay compression is an inappropriate relationship between a supervisor and a direct employee. Overtime, specialized skills, new hire compensation, and market pay can all contribute to pay compression between a supervisor and a direct employee.

A good rule of thumb is that supervisors should be paid 10% or more above their highest paid direct reports' salaries. Working supervisors should be paid 5% or more above the direct reports' salaries. When assessing the compensation relationship between an employee and supervisor, it is important to review taxable income to ensure that overtime pay is included.

A common compression issue is when a highly paid, hourly employee receives equal or higher pay than the exempt supervisor who works comparable hours but does not receive overtime pay. The example below is a simple analysis to assess the pay relationship and the recommended, revised supervisory pay:

Example - Calculation to Rectify Supervisory - Employee Pay Relationship

	Current Base Pay	W-2 Pay with Overtime
Employee	$38,000	$44,000
Supervisor	$45,000	$45,000
Adjusted Supervisor	$48,400	$48,400

+10%

When implementing an adjustment to a supervisor's pay to correct a salary compression issue, either the base salary or bonus can be adjusted to attain the desired pay relationship between the employee and supervisor. The issue can also be rectified if the supervisor becomes eligible for overtime.

Occasionally, a highly specialized employee (typically at a professional exempt level) will be paid higher than his/her manager. This most frequently will occur within the career ladders for engineers, software developers, scientists, and technical sales. In this instance, the market supports the higher pay level for these highly specialized employees, and adjustments are not normally necessary at the manager level.

Minimum Wage, Adjustments to Minimum & FLSA Overtime Thresholds

As significant changes take place to minimum wages and even adjustments to salary range minimum, the increased employee compensation at this level will likely cause compression issues within an organization.

So how do you manage the pay relationship of more experienced and valued employees with those employees impacted by an adjustment?

Some organizations may create an equity budget to support the process of increasing employees near the bottom of the range and maintain equity as adjustments to minimum and minimum wage take place.

A matrix can also be applied as a tool to relieve compression issues throughout an organization, as in the following example:

Example - Compression Management Matrix

Performance Rating	Desired Compa Ratio*									
	Years of Experience									
	0	2	4	6	8	10	12	14	16	18
5	0.85	0.90	0.95	1.00	1.05	1.10	1.15	1.20	1.20	1.20
4	0.82	0.86	0.88	0.94	0.98	1.02	1.06	1.10	1.14	1.18
3	0.80	0.83	0.86	0.89	0.92	0.95	0.98	1.01	1.04	1.07
2	0.80	0.82	0.84	0.86	0.88	0.90	0.92	0.94	0.96	0.98
1	Performance Improvement Plan/Employee Exit									

*Matrix assumes a 50% salary range spread

Although the desired compa ratio, years of experience, and performance rating within the matrix may vary from company to company, it is a helpful tool to identify and manage compression issues. A matrix can also serve as a guideline to support in the distribution of an equity fund to alleviate compression throughout an organization.

It is important to manage pay compression for employees whose experience, responsibilities, performance level, and compa ratio are not properly aligned in an organization. Equity adjustments should be managed for these employees.

Promotions & Career Ladders

Career ladders are an important tool to organizations in order to ensure appropriate growth and development based on an employee's role and responsibilities. Technical career ladders used in Research & Development are important to provide career opportunities managerially or non-managerially, as in the following scenario:

Level	Nonmanagement Ladder	Management Ladder
7	Senior Fellow	Vice President
6	Fellow	Senior Director
5	Senior Principal Engineer	Director
4	Principal Engineer	Manager
3	Senior Engineer	
2	Engineer	
1	Associate Engineer	

Career ladders will also reduce turnover and compression when applied appropriately. It allows an employee to be recognized for his/her expanded role, experience, and responsibilities through an appropriate job, level, and pay rate.

When managing compression, employees paid too high relative to their marketplace and salary grade should also be closely reviewed to determine if they should be considered for a promotion or managed at the next higher level. Sometimes the job evaluation, salary grade, or uncompetitive range may be the issue. Decisions such as these should be carefully reviewed but should be a viable course of action when appropriate. It is important to assess if the move will create additional compression issues or successfully resolve the issue.

Departments who manage their promotions with transparency among their management team are one step ahead of their competitors and will support in managing internal equity across their department. An R&D Department that manages promotions as a management team is taking an important step in minimizing compression issues throughout their organization.

Organizations that promote from within, rather than hiring externally, are also contributing to the reduction of salary compression.

Mergers & Acquisitions

The process of mergers and acquisitions can create its own set of compression issues as well. Clearly, integrating two businesses early in the process is beneficial since the acquired business is highly motivated and will take the necessary steps to close the acquisition. However, the motivation is typically lost when the integration takes place well after the acquisition or merger.

A business will have a few options in managing the compensation integration:

- Integrate upon close
- Integrate at a later point in time
- Partial integration upon close and second review 6-12 months after close
- Do not integrate

Taking the required time and steps to fairly and equitably manage internal equity and market competitiveness when integrating two businesses is important. Making liberal salary adjustments too early may actually cause more compression issues than it will solve. When in doubt, take a more conservative approach upon integration with agreement to review again in 6-12 months after the new manager can better assess the role, performance, and experience of the acquired workforce.

Inconsistent Pay & Performance Management Practices

Inconsistent pay practices can be caused by varying management styles and assessment techniques throughout an organization. Training can help reduce inconsistencies in performance assessments, as well as minimize inconsistent pay practices.

Department heads who manage pay and performance standards, assessment, and internal equity well will minimize compression issues throughout the company. Human Resources can support this process by ensuring that the necessary training, tools, and reports are provided to maximize the effectiveness of the management team. A transparent dashboard of performance and salary increase practices by department can be effective to manage increases throughout an organization and support in minimizing salary compression as well.

Underperformers should also be reviewed. Would they be better managed in another job, should their pay be frozen, or should they receive lump sum increases in lieu of regular merit increases to their base salaries?

Out-of-Cycle Increases

Out-of-cycle increases, if not carefully managed, can create additional compression problems within an organization. Occasionally, a manager will recommend a very high special adjustment for an employee without regard to other comparable pay relationships within an organization.

A department head's approval as well as Human Resources guidance and analysis can help ensure overall internal equity is attained.

Pay Equity Laws

State and federal pay equity laws in the United States, as well as those implemented globally, may require a pay equity analysis to mitigate risks throughout an organization. Law firms are developing specialized expertise in pay equity compliance and analysis. The steps may include aligning a business' short- and long-term objectives and pay practices (actual and recommended) to ensure pay equity compliance while meeting business operational requirements.

The funds for managing pay equity and compression issues within a company may be limited. It is important, though, to not overlook pay compression while attempting to manage pay equity. By budgeting appropriately, there is an opportunity to resolve pay equity issues, as well as ensure pay compression is minimized as a result of the review.

Salary Administration & Low Salary Budgets

Managing low salary increase budgets throughout the United States for almost 10 years also may have created various compression issues throughout organizations.

It is important to truly manage pay for performance. Administering merit opportunity for top performers at just 150% of competent performance using a 3% merit budget may not be sufficient to move your top performers to desired compa ratio levels. It creates rather than reduces compression issues. Consider stretching the formula for your merit matrix from 150% of budget for top performers to 200% or even 250%, as in the following calculations, to support in relieving pay compression:

0-150% FORMULA

Performance Rating	% Occurrence	Under Midpoint			Over Midpoint			Actual % to Spend Based on % Occurrence
		Merit Increase %	% Occurrence	Formula	Merit Increase %	% Occurrence	Formula	
5 - Far Exceeds Expectations	10%	4.50%	50.00%	150%	3.75%	50.00%	125%	0.41%
4 - Exceeds Expectations	20%	3.75%	50.00%	125%	3.00%	50.00%	100%	0.68%
3 - Meets Expectations	55%	3.00%	50.00%	100%	2.25%	50.00%	75%	1.44%
2- Sometimes Meets Expectations	10%	2.25%	50.00%	75%	1.50%	50.00%	50%	0.19%
1 - Does Not Meet Expectations	5%	0.00%	50.00%	0%	0.00%	50.00%	0%	0.00%
Merit Increase Budget	100%	3.00%						2.72%

0-200% FORMULA

Performance Rating	% Occurrence	Under Midpoint			Over Midpoint			Actual % to Spend Based on % Occurrence
		Merit Increase %	% Occurrence	Formula	Merit Increase %	% Occurrence	Formula	
5 - Far Exceeds Expectations	10%	6.00%	50.00%	200%	4.50%	50.00%	150%	0.53%
4 - Exceeds Expectations	20%	4.50%	50.00%	150%	3.00%	50.00%	100%	0.75%
3 - Meets Expectations	55%	3.00%	50.00%	100%	1.50%	50.00%	50%	1.24%
2- Sometimes Meets Expectations	10%	1.50%	50.00%	50%	0.00%	50.00%	0%	0.08%
1 - Does Not Meet Expectations	5%	0.00%	50.00%	0%	0.00%	50.00%	0%	0.00%
Merit Increase Budget	100%	3.00%						2.59%

0-250% FORMULA

Performance Rating	% Occurrence	Under Midpoint			Over Midpoint			Actual % to Spend Based on % Occurrence
		Merit Increase %	% Occurrence	Formula	Merit Increase %	% Occurrence	Formula	
5 - Far Exceeds Expectations	10%	7.50%	50.00%	250%	5.25%	50.00%	175%	0.64%
4 - Exceeds Expectations	20%	5.25%	50.00%	175%	3.00%	50.00%	100%	0.83%
3 - Meets Expectations	55%	3.00%	50.00%	100%	2.25%	50.00%	75%	1.44%
2- Sometimes Meets Expectations	10%	1.50%	50.00%	50%	0.00%	50.00%	0%	0.08%
1 - Does Not Meet Expectations	5%	0.00%	50.00%	0%	0.00%	50.00%	0%	0.00%
Merit Increase Budget	100%	3.00%						2.98%

Salary Structures

Salary structures which have not kept pace with the marketplace may become outdated, and compression issues will become more prevalent. An annual salary structure analysis and adjustment will typically be sufficient to remain competitive in the marketplace. Keeping an eye on "hot" jobs in the marketplace is also an important competitive approach. Salary structures which are either too narrow or too broad can contribute to salary compression issues. Also, a salary structure with too many salary grades and a low midpoint progression from grade to grade can also lead to salary compression. It is important to keep your internal workforce moving consistently with the outside labor market, while also ensuring internal equity.

Job Descriptions, Job Evaluations & Market Pricing

Just like halos in performance management, job documentation, job evaluations, and market pricing can become inflated as well. When a job description and the resulting job evaluation are inflated, the pay of the incumbent then also becomes inflated. As a result, pay compression may occur among other jobs and employees. It can set off a chain reaction in equity adjustments and job evaluations. To minimize this type of pay compression, it is important to identify potential inflation and maintain an equitable relationship between jobs.

Assessing Salary Compression within an Organization

A regular salary compression analysis (at least annually) should be conducted within an organization. The analysis can also serve as the justification to obtain the required equity fund (budget) to correct identified compression issues. When incorporated with the salary increase budgeting process, the management team can then plan for this regular review and the related expenses to correct pay compression issues.

During these years of flat merit increase budgets, an equity fund will normally be welcomed by management to support in resolving compression issues identified by a salary compression analysis.

Benefits of Managing Salary Compression

Salary compression can and should be proactively managed. Once top management is aware of and owns the web of issues caused by salary compression, it is likely they will initiate proactive steps to resolve the issue.

Managing salary compression will reap many benefits, including the following:

- Reduced turnover
- Improved productivity
- Improved employee-management relations
- Increased employee engagement
- Increased performance
- Improved trust and morale
- Opportunity for increased pay transparency

Summary

You are not alone—salary compression is a common issue. The vast majority of companies suffer from pay compression, whether it is caused by minimum wage changes, pay equity laws, FLSA changes, stagnant salary increase budgets, mergers and acquisitions, new hire compensation, supervisor-employee pay relationships, or a variety of other reasons. The multitude of events occurring in this last decade has only compounded the number of items contributing to salary compression. Incorporate an analysis of pay compression into your annual salary plan to ensure that your management team identifies, owns, and remains committed to resolving this important issue.

ERI's cloud-based Salary Assessor software is used by organizations of all sizes to compare internal pay practices with market salary ranges. Salary planning features equip subscribers to identify and resolve salary compression issues. ERI also provides the Occupational Assessor software to help users determine employees' FLSA status. Try a free demo of ERI's Assessor Series today!

Please email Linda Cox at linda.cox@erieri.com with questions or comments.

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