

Addressing Salary Compression in Any Economy

It is difficult not to cringe when a manager says blithely, “Who cares about salary compression? Nobody is quitting in this economy just because they suspect they’re being paid less than the next person.” In fact, minimizing salary compression is an issue in any economy. As soon as a down market begins to turn around, simmering discontent tends to escalate rapidly at all organizations but especially at companies that froze or reduced incumbents’ wages during tough times. Companies should be

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QUICK LOOK

- ➔ Compression may be tolerated at extremely innovative companies whose culture is to pay whatever it takes to get the best talent.
- ➔ During the past five years, the influx of Millennial/Gen Y workers has rendered pay level discretion a thing of the past.
- ➔ Sixty percent of respondents said they do not address compression differently based on the level of employees.



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looking ahead and taking steps now to deal with compression before it becomes a problem.

Penny-Wise, Pound-Foolish

Salary compression occurs when there are little or no differences in pay, coupled with large differences in responsibilities, skill level or qualifications. The inequity may occur between supervisors and subordinates, between new and experienced personnel in the same position, or between pay-range midpoints of successive job grades or related grades across pay structures. Compression is rarely a deliberate compensation strategy, although (as discussed in more detail later) it may be tolerated at extremely innovative companies whose culture is to pay whatever it takes to get the best talent with the latest skills. However, compression should never be promoted with the intention of encouraging lower-performing employees to leave the organization because such a strategy could damage the reputation of the company.

Experience has demonstrated that over the long term, companies pay the cost of ignoring problems related to salary compression. An example would be an organization that has one investment analyst — a loyal, smart and dedicated employee who has made the company buckets of money through smart investments. The company decides to grow the department by adding a second investment analyst, who will be trained by this star employee to perform the same work. When the organization discovers that no qualified candidate is available at the star employee's level of pay, it is forced to offer the new hire a 10-percent-higher base salary. While it brings that desired candidate on board, there needs to be a related pay adjustment for the existing investment analyst. Since a truly stellar employee can find a great job in any economy, the company should increase its incumbent top performer's base pay to exceed or at the very least match that offered to the new hire. If not, the incumbent will almost certainly start looking for a new

job upon learning of the pay disparity. The increase of a few thousand dollars per year to the existing employee's base salary is small in comparison to what it would cost the company to recruit, hire and train a replacement.

External Influences on Salary Compression

Two significant influences on pay compression have emerged in recent years. The first trend is a major increase in salary transparency among the Millennial Generation. Younger employees' openness about discussing salary levels is a troublesome trend because it brings compression issues to the surface. Until fairly recently, employees rarely knew if compression existed because Traditionalists and Baby Boomers regarded pay levels as private. During the past five years, the influx of Millennial/Gen Y workers has rendered such discretion a thing of the past. They have few reservations about sharing their salary information with colleagues, friends and even strangers on the Internet. Be assured

that employees — now more than ever — will find out, either first- or second-hand, if they are being paid inequitably.

The second recent external influence on pay compression is the July 2009 increase in the U.S. federal minimum wage from \$6.55 to \$7.25 per hour. This change will create pay inequities in organizations that employ minimum wage workers unless the companies adjust compensation levels for employees who were previously earning at or slightly more than \$7.25 per hour.

A Look at Market Trends

A May 2009 survey by Pearl Meyer & Partners, *Salary Compression Practices in the United States*, offers insight to companies' experiences dealing with compression issues. Seventy-seven organizations across a range of industries, geographies and company sizes participated.

The survey found salary compression to be most common in the information technology and engineering/science industries, where equipment and skills change rapidly. Because of such companies' constant need for technical talent with the very latest

skills (e.g., programming languages or project management certification), employers will more readily offer premium pay to new employees who have rare technical expertise, even if they will be performing essentially the same job as lower-paid incumbents. In such situations, compression often is accepted as a lesser evil than failing to bring desired candidates on board.

Generally, the survey found compression more prevalent at the individual-contributor level than for management positions. This is not surprising given that pay levels among individual-contributor positions usually vary by 10 percent to 20 percent per level, versus differences of upward of 30 percent at the management level. Individual-contributor levels generate more compression because their pay range midpoints are much closer together, offering less leeway to differentiate pay without leading to compression. Sixty percent of respondents said they do not address compression differently based on the level of employees, suggesting that most organizations take a

one-size-fits-all approach to dealing with compression.

Forty-three percent of organizations said they have completed a compression-related salary adjustment within the past two years. Of those, 83 percent expressed satisfaction with the outcome of the resulting salary adjustments, strongly indicating that companies can effectively address and ameliorate compression.

Survey participants were asked to indicate how morale, retention, productivity, work relationships and job satisfaction were affected by pay compression. Figure 2 reports the survey results that showed that compression was judged to have the greatest impact on morale, retention and job satisfaction — all issues closely linked to excessive turnover.

Avoiding Compression

Changes in the economy and labor shortages/surpluses are obviously not within the control of human resources. However, companies can manage other internal factors related to compression, such as hiring practices, merit

FIGURE 1: WAS THE COMPRESSION-RELATED ADJUSTMENT SUCCESSFUL?

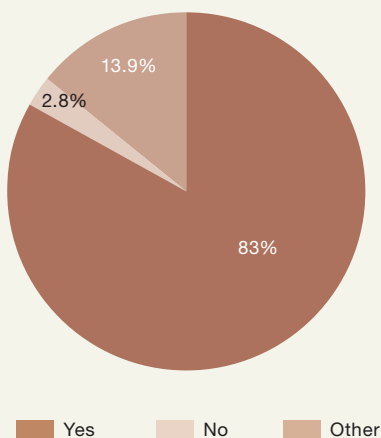
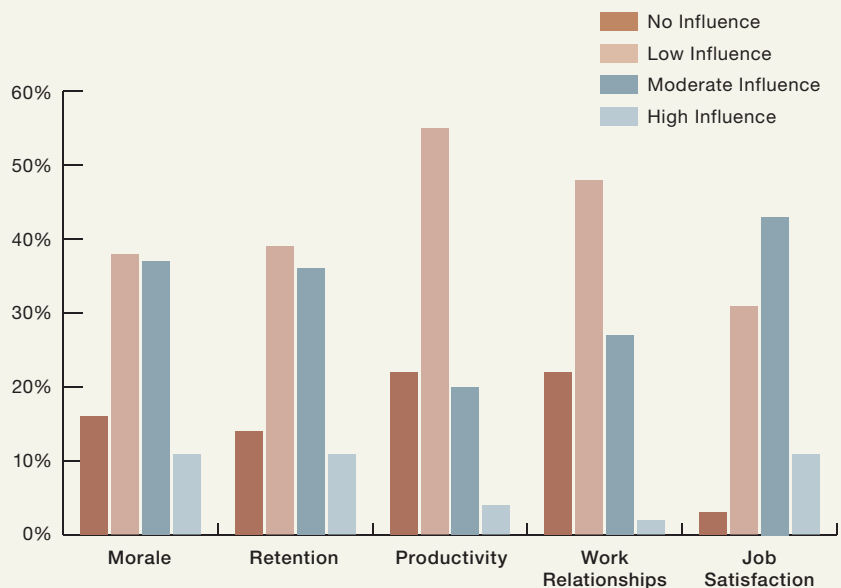



FIGURE 2: AREAS NEGATIVELY AFFECTED BY PAY COMPRESSION



increase programs and salary structure guidelines. Following are some practical approaches to preventing and addressing compression:

- **Communication with managers** — Hasty, reactive hiring decisions made to quickly fill vacancies often result in salary compression. The HR department can address this issue by clearly communicating the organization's pay philosophy and strategy, so that management appreciates the multiple negative effects of compression in the workplace. (See Figure 2.)
- **Communication with employees** — An organization's compensation philosophy and pay practices should not be treated as a matter of interest only to management, but promoted to all employees. As many companies have discovered, even the perception that people are being compensated unfairly can be as damaging to employee morale and performance as actual pay inequity. Knowing that their employer recognizes and is employing tools and procedures to avoid problems with compression will reinforce employees' confidence that their own compensation is fair.
- **Sign-on bonuses** — Along with serving as one of the most effective enticements for job candidates to accept a position quickly, sign-on bonuses reduce the potential for pay compression by providing new hires with a one-time-only premium payout, rather than an ongoing compensation increase.
- **Variable pay** — Similarly, cash incentives tied to performance metrics offer high performers an opportunity to earn more, without creating base pay compression.
- **Non-monetary rewards** — Programs like flexible work schedules, time off to volunteer, and training and development opportunities offer relatively low-cost ways to enhance the total rewards package.

- **Salary structures** — Making appropriate salary structure adjustments each year will ensure that midpoint differentials are not too narrow, allowing for sufficient salary growth from one level to the next.
- **Market competitiveness** — Keeping up-to-date on market rates helps ensure pay is competitive and the placement of positions makes sense within the salary structure. As the economy recovers and companies have more cash, market adjustments should be made for employees whose pay was frozen or reduced.
- **Performance-based merit awards** — Merit pay increases for top performers should be sufficiently significant not to create compression.
- **Off-cycle merit adjustments** — In recent years, the pay rates for new college graduates in many disciplines has increased faster than average overall merit increases, resulting in inequities between compensation for new graduates and for incumbents with one or two years' experience. Adjusting pay rates for new college hires or other key personnel throughout the year — rather than limiting changes to once annually, which is the policy at many companies — is an effective proactive approach to avoiding salary compression. Such off-cycle merit adjustments, which can be used at all levels in the organization, are increasingly commonplace for new college-graduate hires.
- **Lump sum merit awards** — It is common for long-tenured incumbents to be "red circled," or paid very highly within the salary range, resulting in salary compression if their pay exceeds that of incumbents in higher-level positions. Lump sum merit awards allow employers to recognize and reward the performance of highly paid employees without causing compression.

Salary compression often develops gradually and unnoticed, catching organizations unaware until it is expressed in increased employee dissatisfaction and turnover. In recent years, the problem of salary compression has been exacerbated by the greater willingness of younger workers to share and compare information about their pay levels, revealing possible inequities in their relative compensation, seniority and responsibilities. As the job market begins to pick up, organizations must remain especially attuned to any perception of compression and the risks it poses to their ability to continue attracting, retaining and motivating the talent they need. Rather than adopting a broad-brush solution, companies can customize an effective strategy that directly addresses the concerns of valued employees before they become a real problem. 

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