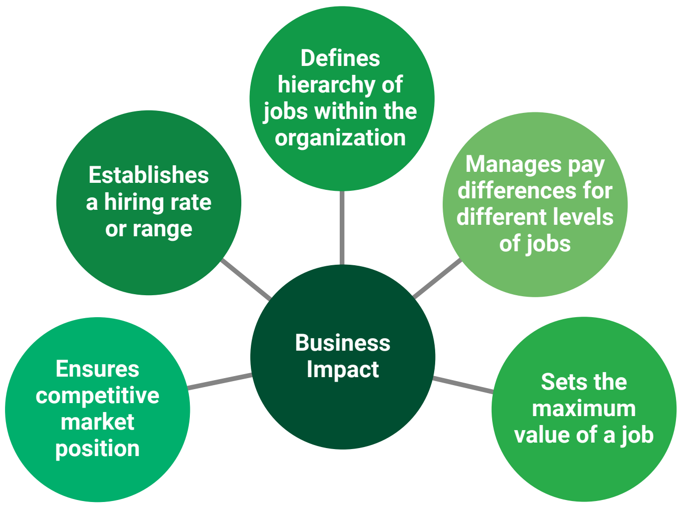
ECONOMIC RESEARCH INSTITUTE

How to Set Competitive Compensation Structures

HOW TO CREATE A COMPETITIVE SALARY STRUCTURE

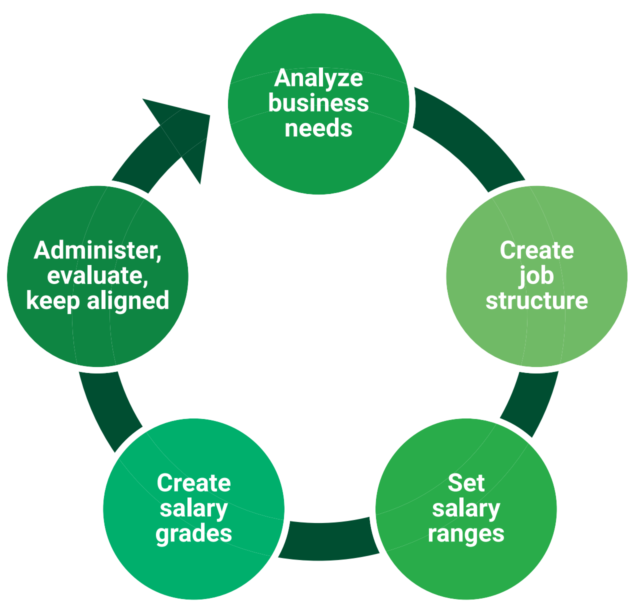
This learning aid serves as a resource for creating a competitive salary structure. Well-designed salary structures have compensation levels that are internally equitable, externally competitive, and cost-effective and deliver a positive business impact on the organization in several ways, as highlighted in the infographic below. Although the technical steps are the focus, the underlying process requires a cross-functional team of stakeholders working collaboratively to create a competitive salary structure.



PROCESS FOR DESIGNING A SALARY STRUCTURE

There are several steps to creating a competitive salary structure. The final structure will have a series of salary ranges and grades that represent the hierarchy of jobs and job families in the organization.

Once introduced, it is necessary to keep the structure current and aligned to support business objectives. Salary structures require maintenance to function properly.



STEP 1: To be effective, tools and programs that directly impact the entire organization (such as a competitive compensation structure) require a needs assessment, which analyzes the following:

- Business strategy
- Corporate culture
- External factors
- Key-performance-indicators (KPIs)

An organization's compensation strategy should align with the company's mission, vision, and culture, as well as support the overall business strategy. In regards to external factors, the competitive market position is defined in terms of how the company wants to compete in the labor markets by paying below market, market, or above market rates. For example, an organization may pay below market rates for low-skilled, high-turnover positions and above market rates for positions that are critical to the organization's mission.

STEP 2: Establish a job structure by conducting job evaluations and market pricing.

A job evaluation is preceded by a job analysis to collect job content. After the job analysis, the jobs are evaluated based on company-specific criteria like compensable factors (see "How to Conduct a Job Evaluation"). Job evaluations create an internally focused nomenclature to communicate similarities and differences across jobs.

For market pricing, internal jobs are matched with benchmark jobs in compensation surveys. To result in a valid structure, at least 50% of the workforce in the organization need to be represented in the benchmark jobs. It is essential to use appropriate salary surveys based on the relevant labor market where an organization recruits employees. Consider the four factors that drive the selection of a relevant survey, as summarized in the infographic on page 3:

Job structure example:

Ranking	Job Family	Job	Competitive Market Rate	Compensable Factor Points
1	Support	Receptionist	34,000	120
2	Support	File Clerk	28,000	110
3	Support	Data Entry	26,000	100

STEP 3: Next, develop grades where jobs are assigned grades based on the job evaluation results and job structure.

Organizations with fluid, organic structures have fewer grades, whereas highly structured organizations have more grades. In practice, the number of grades varies from as few as 4 to as many as 60. Here's an example of a simple grade structure for an organization with $100 million in revenue:

Grade #	Grade Name	Points	Market Rates
10	C-Suite	300+	175K-190K
9	Division Heads	250-299	150K-162K
8	Functional Leaders	225-249	125K-140K
7	Director	200-224	99K-122K
6	Manager	180-199	76K-89K
5	Supervisor	160-179	64K-56K
4	Team Leader	140-159	44K-52K
3	Senior	125-139	34K-38K
2	Intermediate	115-124	26K-28K
1	Entry	100-114	20K-25K

STEP 4: Next, plot job evaluation points and market rates to identify a trend line from the lowest market rate to the highest market rate.

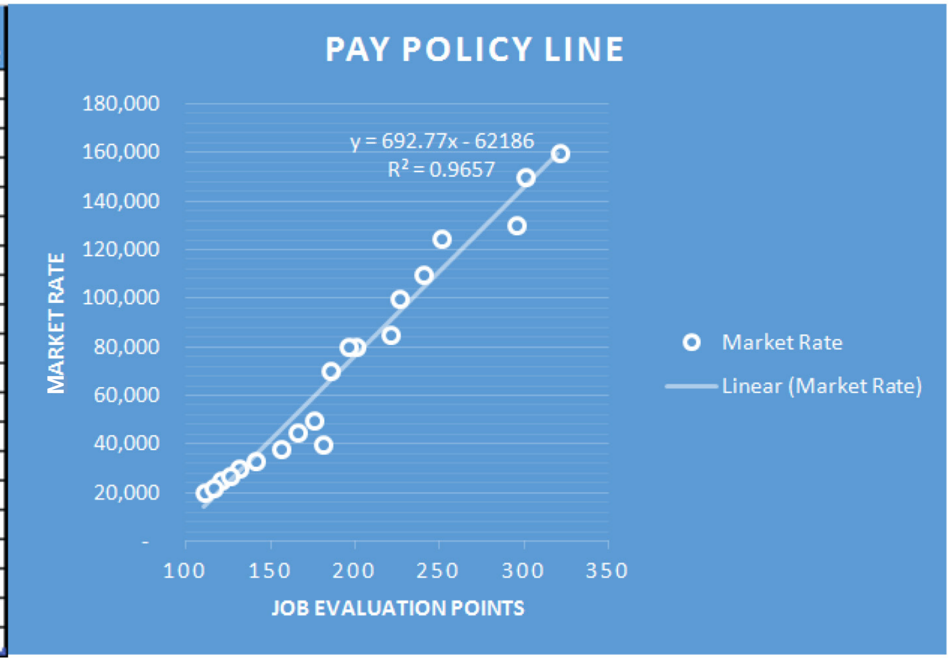
This can be accomplished using simple regression in MS Excel with the scatterplot function. The resultant equation is referred to as a "pay policy line" and is expressed as follows:

$$Y = m(x) + b$$

SYMBOL	DEFINITION
Y	Base salary; dependent (predicted) variable. Found on the Y axis
m	Slope of the line
x	Job evaluation points; independent variable. Found on the X axis.
b	y-intercept

The data set and graph are shown below. Based on this equation, each job evaluation point increases the salary by $692.77. Also, note the R^2 statistic of 0.9657. This is the percentage of the response variable variation that is explained by the equation. As an organization, an acceptable R^2 result should be defined to determine if the results will be used. An acceptable range could be from 0.60 to 0.80.

Evaluation Points	Market Rate
300	150,000
320	160,000
250	125,000
295	130,000
225	100,000
240	110,000
200	80,000
220	85,000
185	70,000
195	80,000
165	45,000
175	50,000
155	38,000
180	40,000
130	30,000
140	33,000
120	25,000
125	27,000
110	20,000
115	22,000



STEP 5: Finally, determine salary ranges, as well as their respective range spread and midpoint progressions, to complete the competitive base salary structure.

A salary range consists of these rates:

- Minimum pay rate (also may be the beginning hire rate)
- Midpoint (the market or competitive market rate)

  Reminder: the competitive market rate is defined in the business needs assessment process and could be below, at, or above the market average.
- Maximum (the highest rate the organization is willing to pay)

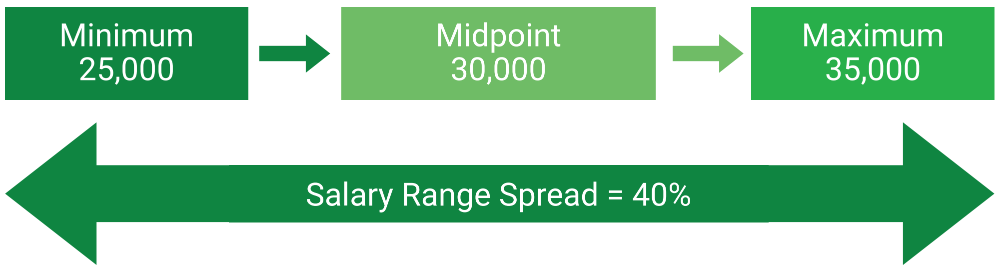
Employees in the same job grade may differ significantly in performance or work characteristics. A "fully performing" employee is likely paid the competitive market rate: the midpoint. New hires start near the minimum, and salaries above the midpoint are for high-performance employees and/or those who have mastery or domain expertise in the job. A salary range spread allows flexibility to account for these differences. It is calculated using the following formula:

$$\frac{\textbf{(MAXIMUM – MINIMUM)}}{\textbf{MINIMUM}}$$

CONSIDER THESE GENERAL GUIDELINES FOR SALARY RANGE SPREADS:

- Service, production, and manufacturing jobs have range spreads of 10-20%.
- Clerical, technical, and paraprofessional jobs have ranges of 20-40%.
- Professional and supervisory jobs have wider ranges of 40-50%.
- Managerial jobs have ranges of 50% or more.

EXAMPLE: RECEPTIONIST SALARY RANGE

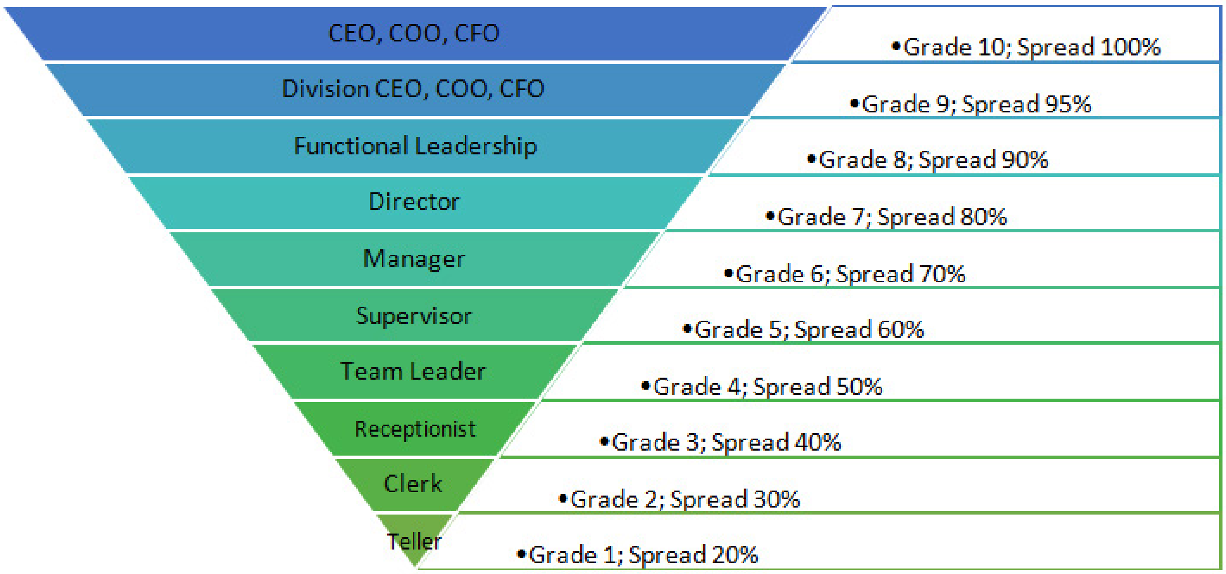


Midpoint progression is the percent difference between the successive salary grade midpoints. Below, some guidelines are presented that build on the same example used earlier showing a structure with 10 grades.

Grade 9 to 10	Progression 12% to 15%
Grade 5 to 8	Progression 10% to 12%
Grade 1 to 4	Progression 7% to 10%

PULLING IT ALL TOGETHER – THE INVERTED PYRAMID CONCEPT

Salary grades for early career professionals or lower-skilled jobs will generally be narrow, and salary progression can be relatively quick depending on the job and individual performance. As the grade increases, ranges get wider and allow for larger increases for jobs in these grades. From a promotion perspective, vertical progression slows down since knowledge, skills, and abilities are more complex, and a longer time period is required to acquire or learn the associated competencies.



SUMMARY

As part of an organization’s strategy, salary is the foundation of compensation packages and an HR financial lever for the organization’s ability to attract, motivate, and retain talent critical for business success. Effective salary structures are equitable, competitive, and supportive of organizational objectives. To successfully manage a well-designed salary structure, it is important to keep a pulse on changing internal workforce requirements and relevant external labor markets. Having the appropriate tools and processes in place to ensure that competitive base salary structures support the business strategy is critical to the long-term health of the organization.

For more information regarding base salaries structures, contact ERI at 800-627-3697 or info.eri@erieri.com.

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