

## How to Put a Lid on Salary Compression, Before it Boils Over

By Jim Kochanski and Yelena Stiles



Organizations' employment and salary actions can create the unintended perception that pay levels are distributed unfairly, which can have undesirable consequences. Consider the not uncommon instance of a 10-year, high-performing employee, who decides to start looking for a new job after learning that a new colleague — who has a great deal of potential and enthusiasm but little relevant experience and whom she has been asked to train in the same role — has been hired at her pay level.

This example illustrates one form of salary compression: when the pay of one or more employees is very close to the pay of more experienced employees *in the same job*. There is another form of salary compression: when employees in lower-level jobs are paid almost as much as their colleagues in higher-level jobs, including managerial positions. (See the sidebar "What Causes Salary Compression?")

When salary compression and the policies that enable it are sustained over several years, it can be demoralizing and lead to widespread dissatisfaction. Employers should be concerned because salary compression transforms the organization's single largest cost from a motivator into a "demotivator."

Moreover, while salary compression is not illegal, it is often accompanied by pay inequities that

### What Causes Salary Compression?

Salary compression has many causes:

- Annual salary increase budgets have been modest for 20 years — somewhere between 2 and 4 percent has been the norm — yet candidates changing jobs or companies expect raises of more than 2 to 4 percent, and thus the salaries of new hires can exceed that of incumbents.
- Reorganizations change peer relationships and can create compression if jobs are not reevaluated.
- In some organizations, certain departments or divisions may be relatively liberal with salary increases, market adjustments and promotions while others are not.
- Some employers have overlooked their HR policies designed to regulate pay, paying new hires more than incumbents for similar jobs under the mantra of paying what it takes to get the best talent.
- Because of the weak job market, many organizations have found it easy to hire people who had already done the same work for another organization, in order to eliminate the need for training. Rather than hiring people with high potential and developing them for the long term, they have opted for people who could "hit the ground running," regardless of their potential.
- In the case of mergers and acquisitions, if the organizations have not been properly integrated, compression may exist in the newly combined organization.

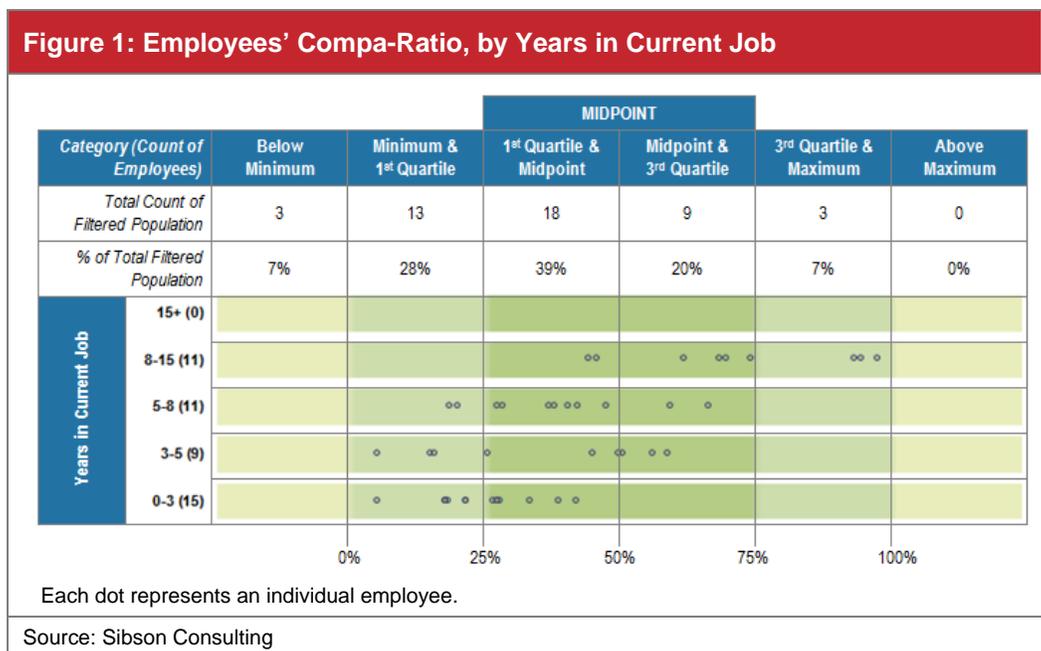
could violate equal pay laws. In situations where salary compression causes *salary inversion* — where newer staff make more than experienced staff — it could create a pay equity problem if the experienced staff are a protected class.<sup>1</sup>

This article looks at how organizations can determine if they are experiencing salary compression. Moreover, because this problem is more costly to fix than it is to prevent, this article will explore what organizations can do to avoid future salary compression.

### How to Tell if Salary Compression Exists

Two straightforward, but effective, analyses can determine if an organization is experiencing salary compression and can help identify specific areas of concern that warrant a closer look:

- **Review the compa-ratios<sup>2</sup> within each salary grade or band by the employees' time in position.** (See Figure 1 below.) While time in position is not the only factor that moves an employee through a salary range,<sup>3</sup> it is a good proxy to start testing for compression within a specific salary grade or band. When shorter-service employees appear deeper in the range (e.g., the third or fourth quartiles) and longer-service employees appear at the beginning of the range (e.g., the first and second quartiles), it is a sign for closer examination.



- **Analyze how supervisors' salaries compare to their direct reports' salaries.** (See Figure 2 on the next page.) While there is no rule for when the salary-compression level becomes dangerously close, a good rule of thumb is to look at areas where direct reports' salaries are more than 95 percent of supervisors' salaries. Areas where direct reports' salaries are 80 to

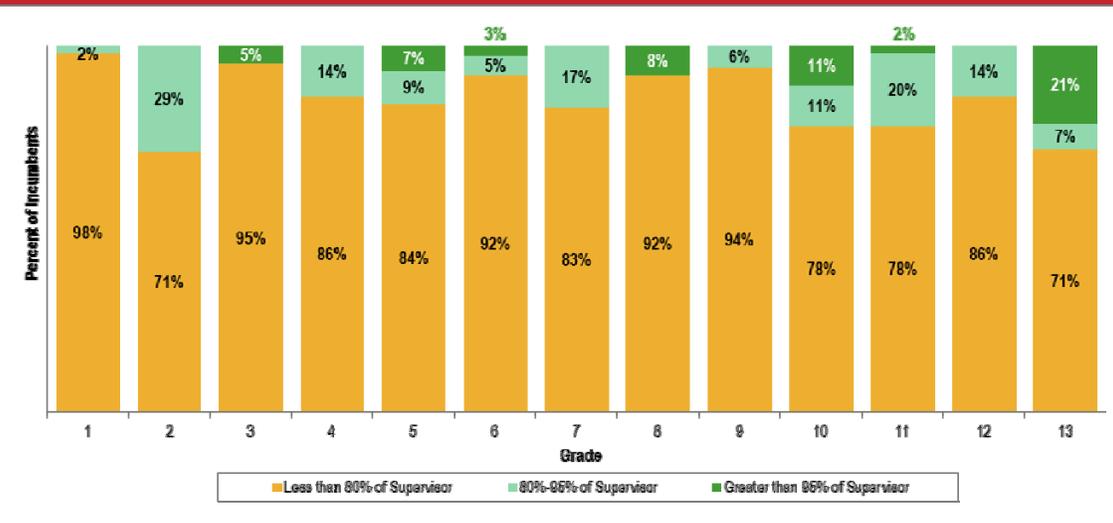
<sup>1</sup> A protected class describes characteristics or factors that cannot be targeted for discrimination. Persons cannot be discriminated against based on race, color, religion, national origin, age (40 and over), sex, familial status, disability status, veteran status and genetic information. Readers are advised to consult counsel.

<sup>2</sup> An internal compa-ratio identifies the relationship of an incumbent's salary relative to the salary range midpoint. It is calculated as the employee's current salary divided by the salary range midpoint for the job the employee occupies.

<sup>3</sup> It is important to remember that other factors, such as performance, may affect an employee's salary movement.

95 percent of supervisors' salaries should be watched carefully for changes that could cause salaries to exceed 95 percent.

**Figure 2: Employees' Annual Salary as a Percent of Supervisors' Annual Salary by Grade**



Source: Sibson Consulting

Most organizations should conduct an analysis annually to monitor the severity of salary compression. Those that have more severe issues, concerns about compression or high turnover rates or do a great deal of hiring may need to conduct an analysis every six months.

### Preventing Future Salary Compression

Although some actions, like low annual raises, reorganizations and other events are effectively beyond HR's control, there are steps that can limit the detrimental effects of salary compression. For instance, when a new job opens, organizations should try to promote someone from within, rather than hiring from the outside. If that is not possible, it is important to:

- Look for high-potential external candidates who are ready to move up into the job and will see it as a promotion. This will limit the organization's need to pay the new hire a premium.
- Control pay both from an HR policy standpoint and from a budgetary standpoint. Managers will usually want the more experienced but higher-cost candidate if there is no policy or cost constraint dictating otherwise.
- Limit how high within a range new hires can be paid. Although HR policies that do so are generally unpopular and thought to be contrary to an organization's goal to "hire the best talent," many effective organizations have such policies.
- Require a review of equity adjustments for incumbents if new hires are brought in at higher salaries. This can encourage managers to think hard about how important prior experience in the same job really is.

Another cause of salary compression that an organization can control occurs when one organizational unit is relatively liberal with salary increases and promotions and other parts of the organization that have the same jobs are not. Strategies to control this include:

- Institute transparency across units, either before or even after compensation actions are taken. In cases where there has been little or no transparency over several years, the disparate actions between different organizational units can create salary compression and other inequities. Transparency can take the form of a simple scorecard showing the rates of increases and promotions in each unit. This tends to create a norm and, over time, leads to decisions that are more consistent and responsible.
- Institute calibration across units. Calibration can involve managers sharing planned compensation actions with their peer managers. It can also include several levels of approval for any actions before they take place so that a senior leader can spot any actions that appear suspect and will cause inequities, including compression.

### Conclusion

The essence of compression is a failure of organizations to make meaningful distinctions among employees and differentially recognize what people are due. Consequently, salary compression can be a serious problem that eventually causes an organization to lose some of its most talented employees. Although many organizations have unintentionally allowed salary compression to take root, there are actions they can take now and in the future to keep it from reoccurring.

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