

7.3: Developing a Compensation Package

Learning Objectives

1. Be able to explain the internal and external considerations of compensation package development.
2. Know how to develop a compensation philosophy.

There are a few basic aspects of compensation packages we should discuss before moving into the specific aspects of compensation. These foundations can assist in the development of a compensation strategy that meets the goals of your organization and is in line with your strategic plan.

Before beginning work on your compensation packages, some analysis should be done to determine your organization's philosophy in regard to compensation. Before development of your compensation philosophies, there are some basic questions to address on your current compensation packages.

1. From the employee's perspective, what is a fair wage?
2. Are wages too high to achieve financial health in your organization?
3. Do managers and employees know and buy-into your compensation philosophy?
4. Does the pay scale reflect the importance of various job titles within the organization?
5. Is your compensation good enough to retain employees?
6. Are state and federal laws being met with your compensation package?
7. Is your compensation philosophy keeping in line with labor market changes, industry changes, and organizational changes?

Once these basic questions are addressed, we can see where we might have "holes" in our compensation package and begin to develop new philosophies in line with our strategic plan, which benefits the organization. Some possible compensation policies might include the following:

1. Are salaries higher or lower depending on the location of the business? For example, orthopedic surgeons are paid higher in the North Central states (\$537,000) than in Hawaii (\$250,000), according to the Medscape Physical report of 2011 (Miller, 2011). Reasons could include cost of living in the area and fewer qualified people in a given area, giving them leverage to ask for a higher salary.
2. Are salaries lower or higher than the average in your region or area? If the salary is lower, what other benefits will the employee receive to make up for this difference? For example, wages might not be as high, but offering flextime or free day care might offset the lower salary.
3. Should there be a specific pay scale for each position in the organization, or should salaries be negotiated on an individual basis? If there is no set pay scale, how can you ensure individual salary offers are fair and nondiscriminatory?
4. What balance of salary and other rewards, such as bonuses, should be part of your compensation package? For example, some organizations prefer to offer a lower salary, but through bonuses and profit sharing, the employee has the potential to earn more.
5. When giving raises, will the employee's tenure be a factor, or will pay increases be merit based only, or a combination of both?

Let's discuss some internal and external factors in determining compensation in more detail.

Internal and External Pay Factors

One major internal factor is the compensation strategy the company has decided to use. Sixty-two percent of organizations have a written, documented compensation policy (Scott, 2011).

Some organizations choose a market compensation policy, market plus, or market minus philosophy. A market compensation policy is to pay the going rate for a particular job, within a particular market based on research and salary studies. The organization that uses a market plus philosophy will determine the going rate and add a percentage to that rate, such as 5 percent. So if a particular job category median pays \$57,000, the organization with a market plus of 5 percent philosophy will pay \$59,850. A market minus philosophy pays a particular percentage less than the market; so in our example, if a company pays 5 percent less, the same job would pay \$54,150. The University of Arizona, for example, posts its compensation philosophy on its website¹:

In order to fulfill its mission, the University of Arizona shall maintain a compensation program directed toward attracting, retaining, and rewarding a qualified and diverse workforce. Within the boundaries of financial feasibility, employee compensation shall be

externally competitive and internally equitable, and shall be based upon performance as recognized within the work unit.

In addition to their compensation philosophy, the university lists compensation objectives, such as “average salaries will be targeted at the average salary levels of employees in comparable positions in our various labor markets.” This is an example of a market compensation policy.

An example of an organization with a market plus philosophy is Cisco Systems, listed as one of the top-paying companies on *Fortune*’s annual list. For example, they pay \$131,716 for software engineers, while at Yahoo! software engineers are paid an average of \$101,669, using a market philosophy. The pay at Cisco reflects its compensation philosophy and objectives:

Cisco operates in the extremely competitive and rapidly changing high-technology industry. The Board’s Compensation Committee believes that the compensation programs for the executive officers should be designed to attract, motivate, and retain talented executives responsible for the success of Cisco and should be determined within a framework based on the achievement of designated financial targets, individual contribution, customer satisfaction, and financial performance relative to that of Cisco’s competitors. Within this overall philosophy, the Compensation Committee’s objectives are to do the following:

Offer a total compensation program that is flexible and takes into consideration the compensation practices of a group of specifically identified peer companies and other selected companies with which Cisco competes for executive talent

Provide annual variable cash incentive awards that take into account Cisco’s overall financial performance in terms of designated corporate objectives, as well as individual contributions and a measure of customer satisfaction

Align the financial interests of executive officers with those of shareholders by providing appropriate long-term, equity-based incentives

An example of an organization with a market minus philosophy is Whole Foods. The executive compensation for Whole Foods is a maximum of nineteen times the average store worker (or \$608,000), very low by *Fortune* 500 executive pay standards, which average 343 times (Allen, 2011). According to John Mackey, Whole Foods CEO, paying on a market minus philosophy makes good business sense: “Fewer things harm an organization’s morale more than great disparities in compensation. When a workplace is perceived as unfair and greedy, it begins to destroy the social fabric of the organization” (Hamner & McNichol, 2011). Another example of an organization with a market minus philosophy is Southwest Airlines. Despite the lower pay (and more hours), the organization boasts just a 1.4 percent turnover rate, which can be attributed not to pay but to the workplace culture and, as a result, loyalty to the company (Eggers, 2011).

There are many reasons why an organization would choose one philosophy over another. A market minus philosophy may tie into the company’s core values, as in Whole Foods, or it may be because the types of jobs require an unskilled workforce that may be easier and less expensive to replace. A company may use a market plus philosophy because the industry’s cutting-edge nature requires the best and the brightest.

Other internal pay factors might include the employer’s ability to pay, the type of industry, and the value of the employee and the particular job to the organization. In addition, the presence of a union can lead to mandated pay scales. Unions are discussed in Chapter 8.

External pay factors can include the current economic state. For example, in June 2011, the US unemployment rate was 9.2 percent, which is quite high for the country. As a result of surplus workers, compensation may be reduced within organizations because of oversupply of workers. Inflation and cost of living in a given area can also determine compensation in a given market.

Once an organization has looked at the internal and external forces affecting pay, it can begin to develop a pay system within the organization. We discuss how to develop a pay system in “[Types of Pay Systems](#)”.

Key Takeaways

- Before beginning work on a pay system, some general questions need to be answered. Important starting points include questions ranging from what is a fair wage from the employees' perspectives to how much can be paid but still retain financial health.
- After some pay questions are answered, a pay philosophy must be developed, based on internal and external factors. Some companies implement a market compensation philosophy, which pays the going market rate for a job. Other companies may decide to utilize a market plus philosophy, which pays higher than the average. A company could decide its pay philosophy is a market minus philosophy, which pays less than the market rate. For example, an organization may decide to pay lower salaries but offer more benefits.
- Once these tasks are done, the HR manager can then build a pay system that works for the size and industry of the organization.

Exercise

1. Think of your current organization or a past organization. What do you think their pay policy is/was? Describe and analyze whether you think it was or is effective. If you haven't worked before, perform an Internet search on pay policies and describe/analyze the pay policy of an organization.

¹University of Arizona, "Compensation Philosophy," accessed July 23, 2011, www.hr.arizona.edu/compensation_philosophy.

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