The Juggling Act

Internal Equity and Market Pricing

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In these turbulent times balancing internal equity and market pricing can help retain employees and avoid pay waste.

In the hiring frenzy of the late 1990s, many employers primarily focused on market pricing in the struggle to attract new employees. Today, the challenge employers face is attracting good employees within a framework of greater corporate cost-consciousness. A key to this dilemma lies in balancing the need for market competitiveness with a focus on internal equity.

2003's Compensation Issues

Organizations are juggling a range of often-competing compensation issues without the adequate tools to measure and deal with them, including:

- Establishing internal equity
- Increasing pressure for market pricing
- High cost of employee turnover
- Cost of replacing underpaid employees
- Corrosive effect of employees perceived to be overpaid
- Potential age, gender and race discrimination suits resulting from pay inequities
- Blending pay plans after mergers and acquisitions
- International and regional pay comparisons
- Containing overall salary costs
- Identifying and paying for work relevance, not just current market value.

To tackle these issues and minimize pay waste (an area of corporate cost often overlooked), a well-founded compensation strategy is needed to address:

- **Internal Equity.** Establishing and maintaining a defensible work classification structure
- **External Competitiveness.** Analyzing and incorporating market data
- **Personal Motivation.** Ensuring employees trust the process of determining compensation and receive some level of motivation from it
- **Financial Responsibility.** Understanding the cost of employment and minimizing pay waste
- **Legislative Compliance**. Preventing discrimination by basing pay on work value
- **Alignment with Strategic Direction.** Viewing compensation as an element of the organization's success strategy and rewarding people for doing the right things in line with the strategy.

Why Worry?

The primary reason for compensation professionals to be concerned with internal equity is that employees are concerned about it. They want to ensure they are paid fairly compared with co-workers and in relation to the market. Experience indicates that few workers in career transitions rank "financial success" above factors such as "challenge," "achievement" and "affiliation" as their main criterion in selecting a new employer. If employees identify with the culture of the company and feel they belong and are contributing something worthwhile, they are less likely to join a competitor for reasons of pay.

Employers who focus solely on market pricing are inadvertently encouraging employees to do the same. Essentially, the employer communicates that the company does not control compensation policy; the market does. In this environment, good employees always will be looking outside and will leave the first chance they get.

A focus on internal equity helps avoid the problem that demand for particular jobs comes and goes but that pay increases, once awarded, compound each year. Many organizations are trying to manage situations in which, for example, IT people with obsolete skill sets are still the most highly paid in the company simply because the market at one time inflated the value of their skills. Managing internal equity, accompanied by a creative approach to skill-contingent pay, begins to address this issue.

The fact that employers would do well to balance a range of factors, including internal equity, with market factors in setting pay levels is borne out by the following question: We all know examples of notoriously low-paying organizations that are still able to attract and retain loyal and happy employees. How can they do this if they do not spend some time considering issues of internal equity?

Why We Gave Up on Internal Equity

"We only do market pricing" and "We don't do job evaluation" have become mantras for many organizations. Whether it's acknowledged, all businesses operate some form of job evaluation in setting salaries. It may not be a professionally designed evaluation methodology, but there always is some semi-formal basis for judging the relative value of one position against other jobs in the organization. The moment someone groups jobs according to some set of criteria as the basis for determining pay rates — however arbitrary — the jobs have been evaluated.

A job grade structure simply is a set of groupings of assessed job size spreads and related salary ranges. If there were no groupings of jobs of similar size and there were 100 positions in a business,

QUICK LOOK

- Compensation professionals juggle many compensation issues without the right tools or measures.
- A well-founded compensation strategy will address issues and minimize pay waste.
- Though it may not be a professionally designed evaluation method, all employers operate some form of job evaluation when setting salaries.
- Internal equity and market pricing should not be seen as mutually exclusive or as alternatives to one another.

each with a distinctly different level of value, there would, in effect, be 100 pay grades. Plotting and administering individual job values in this way would be quite possible with a modern computer system, but rarely would be practical.

Traditional job evaluation systems (the way internal equity used to be measured) were expensive and time-consuming to establish and maintain, as they required numerous consultants to come into the organization, develop job descriptions for each job and evaluate job size based on the descriptions.

The viability of this approach diminished dramatically in the 1980s and 1990s as the pace of change accelerated and employers no longer could afford the time, effort or cost required to establish internal equity using traditional job evaluation systems. The demise of these systems was exacerbated by the fact that employees and managers alike were skeptical of a job evaluation in which they had limited or no participation. As there were apparently few alternatives, the largest compensation consultancies began promoting market pricing at the expense of internal equity.

Balancing Internal Equity and Market Pricing

Internal equity and market pricing should not be seen as mutually exclusive or as alternatives to one another. Internal equity plays some part in pricing jobs, regardless of how much it is ignored in many companies. In the ideal compensation system, internal equity is the foundation for compensation, ensuring there is a sound relationship between what people in the business do and what they earn. Internal equity should reflect and reinforce the organization's people strategy. For the business to succeed, its people need to work effectively with each other in teams. This close collaboration cannot occur if it is undermined by competition between employees that is fueled by an over-emphasis on market pricing.

Once this platform of internal pay relativity has been established, the next step is to look at what the salary markets say about pay in the organization. The output of salary surveys is only as good as what has been input into the survey by each responding company. Was the input performed by a compensation professional, or left to the receptionist to key in between phone calls? The most reliable survey information occurs when several surveys yield consistent results for the same job.

When there is no match to the survey for the position, companies usually slot the job, choosing an approximate match to fit the job between other jobs. This can be time consuming and may result in the position being paid inappropriately. If it is underpaid, the company is at risk of losing a valued employee with a range of obvious and hidden costs, including loss of productivity while the position is vacant, recruitment costs, lost time due to interviewing, training costs and the time required for the new employee to come up to speed.

If the position is overpaid, the amount of the overpayment is not the only cost; the demotivating effect on other employees of this perceived inequality, though hard to quantify, is just as real. Either way, the costs of slotting can be hard to track and quantify, but are considerable. Compensation professionals have a real opportunity to contribute to the corporate bottom line by addressing the issue of waste pay.

What to Look for in a Compensation Program

A modern compensation system avoids the problem of pay waste by providing sophisticated tools for determining internal equity as well as market pricing, even for the jobs that do not match a salary survey exactly. Ask the following questions about the system under consideration:

- Does the system establish internal relativities for all jobs to form a sound basis for market comparisons?
- Is the system fast and easy to maintain?
- Can jobs be evaluated to determine internal equity without the need for job descriptions?
- Does the process elicit up-to-date job knowledge and foster "buy-in" at all levels by involving jobholders and their managers in the evaluation methodology?
- Do jobholders and managers "nod their heads" at the evaluation result?
- Was the system designed for computer use from the beginning (computerized evaluation input and calculation)?
- Is the evaluation methodology integrated with sophisticated compensation management tools (e.g., graphing, reporting, market comparisons, pay modeling, salary review, salary tables, calculation and storage of HR and compensation information)?
- Does the vendor provide tools for transition to the new economy, such as processes and software for work viability measurement and success building? WS

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