# Compensation Philosophy:
# Principles Guiding Compensation Strategy

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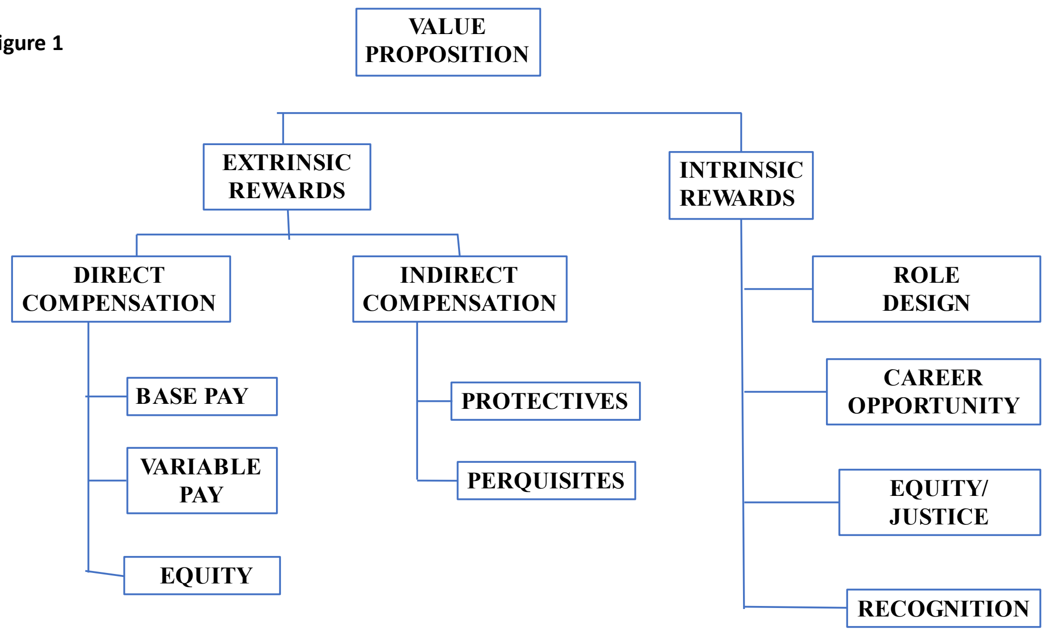
Organizations must brand themselves as employers of choice in order to attract and retain the right talent. The brand communicates the values of the organization, its culture and how it values and treats its people. Decisions about what type of brand the organization wishes to create are typically made by the Board, working with executive management, due to the importance of how the organization is viewed as an employer in determining its success. The brand is also a signal to investors as to what the organization offers and how it intends to achieve success.

A significant component of the brand is the value proposition that is offered to talent. It consists of all the conditions of employment and what the organization offers in return for the contributions of workforce members. Figure 1 illustrates the components of a value proposition.

**Figure 1**




The components of the value proposition offered by organizations vary. Some employers will stress non-monetary items such as career opportunities, an attractive culture, meaningful and challenging work, recognition and fair treatment. The decision as to what is offered may be based on the values the organization embraces or may be based on economics. If the available resources preclude competing with other organizations on compensation and benefits alone other things may be used.

Public sector organizations and non-profits with a charitable mission are more likely to attract those who value making a difference or serving a cause. Private sector organizations tend to stress monetary rewards more. Yet relying solely on money sometimes does not work well. Henry Ford had to pay much more than other employers to get people to endure the assembly line… and still had turnover of 200% or more. The nature of the organization might impact what can be offered. Public sector organizations face stricter limitations on the type of compensation used (e.g., stock programs are not available). They may also face greater scrutiny by the taxpayers when pay levels appear to be too high and/or service levels are deemed to be unsatisfactory.

Extrinsic rewards may be fixed costs or variable costs. Base pay and benefits costs generally increase each year. Last year's pay increase during good times is not refundable in bad times. Health care costs continue to rise faster than inflation and unless organizations reduce benefit levels or increase the percentage of costs paid by employees the employers costs increase. Salaries and wages can be frozen or reduced in cases where contractual agreements do not prohibit it. However, this can have a detrimental impact on employee satisfaction. People will adjust their standard of living to fit their income stream and reductions can be viewed as a breach of contract (social if not a legal one).

The federal government and many state and local entities use automatic, time-based step increase programs to administer base pay. When revenues drop, as they did at the onset of the pandemic, costs can become misaligned with resources. A similar scenario occurred during the 2007-10 financial crisis. The President publicly proclaimed that federal pay was frozen for two years. It was not… the GS step structure was, but employees continued to get automatic step increases. Using automatic step progression precluded controlling costs. Without reductions in current rates the only way for employers to adjust workforce costs downward to align them with revenues is to reduce headcount, which may mandate terminating people who will be needed when conditions improve.

Organizations must manage compensation in a manner that is sound from a business perspective. One of the most common errors is to be unclear about the impact of the economy on pay budgets and pay adjustments. Employees often think that high inflation rates should be offset with commensurate pay increases, to sustain the purchasing power of their income. However, sustaining purchasing power is not the responsibility of organizations. Economic metrics like inflation, cost of living and unemployment rates do tend to have an impact on labor market conditions.

*But an employer must respond to the cost of labor, and not the cost of living.* Macro-economic metrics like inflation cannot be controlled by organizations. If the cost of labor for occupations changes the organization must consider how it responds to remain competitive. The cost of labor is more strongly influenced by the relationship of supply and demand for specific skill sets than it is by inflation or unemployment. Competitive market pay rates for IT specialists may be increasing rapidly, even during periods of low inflation, caused by a shortage of people who are competent to work with the latest technology. Even during periods of high inflation market rates for skill sets that are not in demand may be static.

## What Issues Does A Philosophy Need to Address?

The Board and executive management need to agree on a compensation philosophy. The answers to a series of questions will shape that philosophy:

- What forms of compensation will be used?
- How will the value of each role be determined? Internal equity? External competitiveness?
- What will influence the budget for employee rewards?
- How will performance be defined, measured and rewarded?
- What process will be used to administer compensation? Who is involved? Who decides?
- How does the organization define its competition for talent?
- What will the organization's competitive posture be relative to prevailing market rates?
- How will the compensation philosophy be communicated and to who?
- When, how and by who is the philosophy evaluated to ensure its continued relevance?

## What Purpose Does a Compensation Philosophy Serve?

A compensation philosophy establishes agreed to principles that will guide how compensation is administered. If the organization commits to paying for performance, however defined, that principle will guide program design and administration. The philosophy can also establish a commitment to values, such as pay equity. Sound compensation management principles prescribe rewarding people based on:

1. The value of the role they play (both to the organization and in the labor market),

2. The person's competence in the role, and

3. The contributions made that help the organization meet its objectives.

What a person looks like, what they believe, where they came from and any other personal characteristics not related to the value they provide should not impact how much and how they are rewarded. A commitment to equitable pay enables an organization to develop analytical processes to monitor pay relationships and ensure they reflect equitable treatment. It also helps to ensure laws and regulations are complied with.

Merely putting a philosophy statement on paper does little… the principles it defines must be adhered to. If employees and other parties-at-interest do not agree with the philosophy management must decide how to address their views. If actual practices are not consistent with the stated principles management must evaluate how programs are designed and administered and determine if changes are required in either the philosophy or in practices. If an organization does not ensure that employees know clearly what is expected and how they are performing on a continuous basis it will make convincing them that they are being treated fairly and appropriately more difficult.

Research supports the principle that paying for performance increases the motivation to perform well. Research also shows that performance must be defined in a manner that fits the situation. For example, using longevity as one of the determinants of pay may be justified if experience in a role is highly correlated with the ability of an incumbent to perform well. Field crew members in a water utility will typically become more familiar with the system, increasing the knowledge and skill they use to maintain the system. When knowledge and skills are organization-specific they can only be acquired by being on the job. A water utility that has a system operated using methods that are not reflected in the engineering plans will find field crew members with extensive system experience valuable. Conversely, newer incumbents in technical fields may have more up-to-date knowledge, making longevity less relevant. An automatic link between longevity and base pay rates makes no provision for reflecting unsatisfactory performance in someone's compensation, making termination the sole consequence available.

The compensation philosophy should also address the methods and processes that will be used to manage performance and to administer compensation.

Adopting a strategy that results in paying people based on the relative internal value of the roles they play may result in using a formal job evaluation system, to ensure the relative internal values determine the grade and pay range assigned each job.

Alternatively, adopting a strategy that results in paying people in a manner that is externally competitive alters the primary basis for establishing pay ranges, since prevailing market rates become the primary determinant. If the philosophy calls for the establishment of externally competitive ranges management must define how the organization defines its competition for talent. A software firm may define its competition for technical personnel as being other software firms… or it may compare to all firms employing people with technical software expertise. The location of other firms may also play a role. Broader labor markets (national or regional) may be used for jobs requiring highly skilled technical expertise, while administrative support roles are measured against local labor market rates. Once an organization defines a competitive arena it must decide on a posture relative to prevailing market rates… above, below or at market averages. If the organization must have superior talent and believes that higher pay will attract personnel of higher quality, it might set pay targets above market averages.

The relationship between the supply of and the demand for a particular skill set will be the primary determinant of market pay levels. Because there are often surpluses of some skills and shortages of others, occupations can vary considerably in the rate at which pay rates increase. An organization may choose to pay above market for occupations that are central to its primary mission and critical to its performance, while paying at or below market for others that have less impact on organizational performance. Since markets are volatile there must be continuous reassessment of the desired competitive posture and of the organization's ability to pay.

One of the conditions of employment that has seen dramatic change recently is the location of work. Historically employees have lived close enough to a central location to enable commuting to that location. But when the pandemic began a large percentage of workers shifted to remote work locations firms discovered that much work can be done without everyone being co-located. Surveys indicate that a significant number of employees do not see the need to return to the central location, at least full time, and do not want to do so. The posture a firm takes about work location may impact the attractiveness of its value proposition. And new issues are created if people relocate to distant places. There has been an outflow of professionals from the San Francisco Bay Area to Northern Nevada and other lower cost locations, bringing into question whether it is still necessary to pay the same rates for someone working elsewhere. Paying those staying in the high pay area the same as someone who now enjoys a lower cost of living and pay that is higher than the market rates in the area they relocate to presents an equity issue.

An employer that is willing to let employees make decisions about where they do their work may be viewed more positively than one mandating that everyone must work in a central location. But the impact of work location on productivity and on the effectiveness of peers and customers must be considered. An employee whose work must be done face-to-face does not have the option to work remotely, while an IT or Accounting specialist may be able to be just as effective from any location. Equity theory suggests people make comparisons to decide about the equity of their treatment and dissatisfaction can result from others having what is viewed as a better deal.

## The Value of a Clearly Articulated and Widely Understood Philosophy

Without a clear compensation philosophy, decisions tend to be made independently by managers, on a case-by-case basis. This can result in inconsistent administration across departments, occupations and time. Philosophies can atrophy in effectiveness over time. Even though a compensation philosophy is a good fit to the context within which it was developed environmental change may necessitate re-evaluating the principles that are being applied. The pandemic has administered an unanticipated shock and being able to call upon a well formulated and clearly articulated compensation philosophy can facilitate sound decisions about how to react to the altered context. Continuous evaluation of the compensation philosophy to ensure it meets current conditions has become mandatory.

Taking the views of all parties-at-interest into consideration when a philosophy is developed and when alterations are being considered can increase the level of acceptance. Although management may be unwilling to hold a democratic election it is important to create an open channel of communication that can gather opinions and enable decisions to be explained once they are made. Dialogue on a continuous basis can engage employees and assure them that their views have been heard and considered. If employees do not get continuous high-quality feedback, they will be unable to determine how to get better and whether they need to ask for the resources they deem necessary in order to perform. Trying to review performance at the end of the year without continuous measurement and feedback will result in managers and employees trying to remember what happened when meeting to discuss the year. The inevitable result will be that they will remember two very different years and what should be a review of events with a document trail will deteriorate into conflict.

In some organizations it may be necessary to customize the compensation system to fit different contexts. Although the principles defined in the compensation philosophy may be adhered to the processes and methods used to administer compensation may vary. For example, in one business unit or function variable pay plans may be used, while in others all direct compensation may be in the form of base pay. And variation across occupations may also be required. Managerial and sales personnel may have a significant portion of their direct compensation in the form of incentive programs that tie rewards to results, while others do not. However, this must be done in a way that is does not violate organizational values or conflict with the culture.

## The Bottom Line

A well-articulated compensation philosophy establishes the guiding principles that underlie sound compensation management. The methods and processes that are used to manage compensation may vary across the organization, due to local contextual differences, but should be consistent with those principles. The philosophy statement communicates a good deal about an organization's values, its culture and its views related to how it values its people and informs all parties-at-interest as to the principles that guide compensation administration. It is a vital element of both the employer brand and the value proposition.

Additional resources are available at:

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