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Choosing the Best Salary Structure for Your Organization

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Salary structures likely will continue to evolve from rigid, internally focused tools to more flexible, market-based designs.

For most of the 20th century, choosing the appropriate salary structure was not a significant issue for most organizations. In the early part of the century, salary structures really didn't exist. Later, as organizations implemented formal salary administration programs (from the 1950s), most implemented what would be described today as traditional salary structures -- those with fairly small incremental midpoint progressions (typically 5 percent to 10 percent), narrow range spreads (e.g., 25 percent to 30 percent) and a relatively large number of distinct salary ranges from the bottom to the top of the organization (usually 15 or more).

Today, the number of salary structure alternatives has expanded to include newer designs, such as broadbands and market-based ranges, as well as previous alternatives, such as traditional structures and step structures. Determining the appropriate structure for an organization has required compensation and HR professionals to gain new expertise regarding the design characteristics, advantages and disadvantages of each type of structure and to be able to defend their recommendations or choice of alternatives.

The stakes in the game clearly have risen, as the chosen salary structure either can support or inhibit the achievement of the organization's strategic compensation, human resources and business goals and objectives.

The Impact of an Appropriate Salary Structure

Implementing an appropriate, effective salary structure can have a number of positive organizational effects. Conversely, a salary structure poorly suited to the organization, outdated or improperly designed can have a number of negative organizational effects. The following is a breakdown of those impacts.

- **Flexibility**. An appropriate, effective salary structure gives managers the flexibility to reward performance, skill development and critical skills required by the organization. This flexibility is largely based on having salary ranges wide enough to encompass market rates for all jobs in the grade, as well as critical skills within those jobs. When properly designed and administered, the salary structure supports and enables the "pay for performance" strategy targeted by nearly all organizations in today's results-oriented environment. In contrast, poorly designed salary structures inhibit properly rewarding performance or skill development and may be used as a scapegoat by managers to explain why they couldn't adequately reward performance or reflect increased responsibility.

- **Philosophy**. An appropriate salary structure reflects the compensation philosophy of the organization, including the targeted market competitiveness for base salary and the appropriate pay level for total cash when base salary is paired with incentives. Reviewing the competitiveness of the salary structure, either annually or at least biennially, ensures the competitiveness of the structure at the market level stated in the organization's compensation philosophy. This may mean ensuring that midpoints are positioned at the market median or that range spreads encompass the 25th, 50th and 75th percentiles for jobs within the grade.

If the organization offers incentives, it also is important for the structure to be positioned at the appropriate market level to provide the targeted level of total cash compensation. For example, if the organization has a stated total cash compensation philosophy of paying at the 60th percentile for performance, which meets expectations, positioning the salary range midpoints at the 60th percentile may result in exceeding the total cash compensation target (depending on the incentive opportunities offered). To avoid this scenario, it is important to analyze the total cash compensation resulting from the midpoint and target incentive opportunities for jobs in each grade and adjust either the midpoints or incentive opportunities accordingly. The appropriate adjustment will be influenced not only by the targeted level of competitiveness for base salary and total cash compensation, but also by the organization's philosophy toward desired pay mix.

- **Control**. A properly designed salary structure effectively controls overall base salary costs, while accurately reflecting the competitive market values of jobs in the grade. Besides making administration of a salary management system easier by grouping "like jobs" together in the same grade, a well-designed salary structure also controls overall salary costs by providing a cap on the range of reasonable market pay for jobs within that grade. For organizations that have large numbers of employees in each grade, this can be a significant control mechanism on salary costs. This aspect of the salary structure also underscores the need to ensure that jobs are placed in the appropriate salary grades, so to reflect the accurate market rate for the job, thus neither overpaying or undervaluing jobs.
- **Movement**. The movement from grade to grade in well-designed salary structures reflects meaningful career progressions. Salary structures with grades too close together (small midpoint to midpoint progressions) may result in career progressions that fail to provide a meaningful differentiation with the previous grade (assuming the goal is for career progressions to be possible even with one grade progression involved). This not only results in poor career progression rewards but also can create confusion in determining a job's grade when the grades are so similar. Conversely, grades that are too far apart can result in jumps between grades that are really too large and overstate the difference between jobs placed in the two grades. Distantly spaced midpoints also can make it difficult to find a grade that accurately reflects the job's market value, as the best reflection of the true market value may fall between the two grades. Salary range spreads and salary range overlap may exacerbate or mitigate either scenario. If ranges are wider and

midpoints reasonably spaced, movement to the next grade may not have as much impact because significant overlap between the two grades already exists.

By contrast, if the range spreads are narrow, and midpoints fairly widely spaced, significant increases may be required to bring an incumbent up to the minimum of the new grade, possibly overstating the importance of grade change. Narrow ranges also can create undue pressure for promotions or job re-evaluations. For example, managers who want to give employees significant or continued pay increases to accompany movement to the new grade use the vehicles of promotion or re-evaluation when the situation does not warrant such action.

Given the impact of salary structures, compensation and HR professionals first should determine the desired objectives of the salary structure (i.e., greater flexibility in salary rates, more room for rewarding skill attainment or performance, or greater control over reasonable compensation costs) before designing a new or revised salary structure. The following describes four major types of salary structures, including design characteristics, advantages and disadvantages, and the organizations best suited for each type of structure.

Traditional Salary Structures

Design Characteristics

"Traditional" salary structures, or those seen most commonly from the 1950s through the 1980s and even today, typically have range spreads of 20 percent to 40 percent, although some allow wider ranges for management and executive jobs. (See Figure 1.) Some structures have constant range spreads for all ranges included in the structure. Other structures have varying range spreads, with smaller spreads at the structure's bottom, where the learning curve of the job is faster, and larger spreads at the structure's top, where the learning curve is longer and the variance in skills and pay levels is greater. Midpoint progressions tend to be small, usually in the range of 5 percent to 10 percent. This tight midpoint progression typically results in a salary structure with a large number of grades to accommodate all organizational jobs.

According to the 2001 *William M. Mercer Policies and Practices Survey*, 75 percent to 80 percent of respondents report using traditional salary structures for all employee groups except management, where the prevalence drops to 56 percent of all organizations. Of those using traditional salary structures, however, 43 percent report that they are considering increasing the range spread and 38 percent are considering reducing the number of grades in the structure.

Advantages

Traditional salary structures provide significant control of the variance in rates paid for jobs within the same grade -- and, assuming range minimums and maximums are observed, control of the pay that can be earned by incumbents in the same job. As such, this structure provides control over unreasonable salary costs, assuming jobs are placed in the appropriate ranges based on the job's market value. It also ensures that relatively similar rates of pay exist for jobs placed within the same grade, fostering internal equity within the organization.

Disadvantages
The narrowness of traditional salary ranges can make it difficult to pay critical skill experts or other incumbents who command greater market rates of pay competitively within the salary range. Employees who are strong performers can quickly move to the top of the range if the organization has an effective pay-for-performance system and then be “maxed out” or ineligible for continued merit increases if the range maximums are observed as a stopping point for future merit increases. If promotion to another job or grade is the only way an employee who is at the top of the range can receive additional merit increases, undue pressure can be created to re-evaluate jobs or grant “promotions” where no real change in responsibilities actually occurs.

Organizations Best-Suited for Traditional Salary Structures
There are still many organizations today where traditional structures make sense and work well. These include organizations that need to closely control compensation costs or have large numbers of incumbents in the same job. Some examples include banks, insurance companies, manufacturing or health care organizations. Nonprofits also may benefit from the conservative nature of traditional salary structures and expense control, given the fixed stream of revenue that nonprofits often receive from investments or other endowments.

Broadbands

Design Characteristics
Broadbands are somewhat the antithesis of traditional salary structures. Broadbands, typically designed with range spreads of 80 percent to 120 percent or more and midpoint differentials of 20 percent to 25 percent, are salary structures with a series of relatively few wide bands, which encompass all of the organization’s jobs. Broadbands offer much more flexibility in terms of differentiating pay for varying skill or performance levels within the same grade.

Broadbands received a large amount of interest and attention in the mid-’90s from organizations seeking an alternative to restrictive salary ranges. As such, broadbands represented a way to break down restrictive ranges that prohibited paying market competitive rates or rewarding individual performance that went above and beyond the range of typical achievement. However, after pilot programs and implementations in many organizations, the initial romance with broadbands seems to be waning, in many cases replaced with a quagmire of unanticipated administrative headaches or too little structure to make decisions with regard to appropriate rates of pay or internal equity. In the *Mercer Policies and Practices Survey*, fewer than 15 percent of the respondents reported having implemented broadbands for any of the employee groups in their organization.

Advantages
The reason for broadbandings’s initial interest and popularity was mostly flexibility. This flexibility includes the ability to place a group of jobs with similar duties, but perhaps different market rates, within the same band. This can eliminate some of the focus on the job grade and place it onto the job family or peer jobs within the organization. This type of structure also can improve the organization’s ability to move incumbents between different jobs within the organization with fewer concerns resulting from a move viewed as lateral or to a lower position. This, in turn, hopefully

increases the focus on skill breadth and career development rather than job grades and their associated status.

Broadbands increase the ability of the organization to match market rates for various jobs within the band, to differentiate pay based on individual performance and skill level, and to reflect varying levels of competency development within the same band. Broadbands also can reduce the number of requests for job re-evaluations or promotions that are in fact only a means of moving to the next salary grade to get the requisite promotional or re-evaluation increase.

Disadvantages
For all the initial excitement and enthusiasm, however, broadbands have brought several complexities and challenges not fully anticipated. Although the flexibility they offer can be advantageous, the lack of structure also can create confusion -- and chaos. For many organizations that utilize broadbands, the width of the bands, initially viewed as an advantage, has created the need to further define market ranges or zones within the bands which represent more closely the market rates of jobs in the band. Some contend that these market ranges or zones are really just the old salary ranges and grades repositioned within the new bands. Depending on the administrative guidelines adopted around the bands and zones within the organization, they may create the same issues as the previous ranges, if not at least the same level of administrative burden in defining and maintaining the competitiveness of the zones and determining the appropriate zone for each job. (See Figures 2 and 3.)

Broadbands also bring with them the need for more sophisticated levels of compensation expertise -- from both HR professionals and line managers. For broadbands to function effectively, market rates need to be determined for jobs within the band and those rates interpreted by the managers or HR professionals utilizing the bands. Salary increases may be less structured in a broadband system, requiring a higher level of expertise on the part of those managers determining and allocating increases for competency and skill development as well as performance.

Organizations Best Suited for Broadbands
Organizations best suited to implement broadbands are those with managers well-trained in compensation and salary administration decision-making; organizations where flexibility is valued and structure is seen as restrictive and counterproductive; or startup organizations where a simple structure providing maximum flexibility and minimum administrative time are required, at least until the organization grows and a more formal compensation function is in place to develop or administer a more traditional compensation structure and program.

Market-based Structures

Design Characteristics
Market-based structures, a term to describe salary structures that fall somewhere between traditional ranges and broadbands, are truly the middle ground between these two extremes and what many organizations seem to be gravitating toward in today's "post-broadband," total rewards era. With range spreads of 30 percent to 70 percent, varying from narrower for lower-level jobs and wider for higher-level jobs and

midpoint progressions of 10 percent to 15 percent, these structures allow for flexibility in meeting market rates while also providing some level of control over unreasonable pay rates or pay levels too far from the range of pay encompassing the 25th, 50th and 75th percentiles for jobs within each grade.

As a means of ensuring the ranges encompass the market rates for all jobs within the grade, various methodologies can be used to develop market-based ranges. A more traditional method of salary structure development is to take the target market competitive rates for all jobs in the grade (i.e., the 50th or 60th percentile) and develop a midpoint representing the average of all jobs. From this midpoint, a range spread and respective minimum and maximum is developed, ideally wide enough to encompass both the first quartile (25th percentiles) and third quartile (75th percentiles) of all or most of the jobs within the grade. This provides a range that reflects appropriate salary levels for incumbents ranging from those with entry-level skills to those critical skill experts or long-term, outstanding performers.

An alternative method for developing market-based ranges would be one where market data for the 25th, 50th and 75th percentile for all jobs within the grade are plotted or arrayed to develop visual and relational representation of the spread for those points within the range. Once this spread is determined, a variable of plus or minus 10 percent or 15 percent above the highest and below the lowest market rates could be applied to develop the top and bottom of the salary ranges (minimum or maximum). This method ensures that rates for all the jobs in the grade are represented, as well as room for entry-level or senior-level employees in various jobs. (See Figure 4.)

Advantages
Market-based ranges have demonstrated an ability in many cases to provide “the best of both worlds” -- flexibility to recognize differing market rates of pay based on performance, skill level or market conditions, but also a reasonable level of control over salary costs and internal equity. This balance has satisfied both line managers desiring flexibility and compensation professionals and senior management seeking some level of control.

Disadvantages
To be truly reflective of the market, more frequent or sophisticated market analysis may be required, but increasing attention to market rates has already been a reality of the last decade, whether market-based pay ranges are employed or not.

Organizations Best Suited for Market-based Structures
Market-based structures have a broad range of applicability in today’s environment, especially given the need to maintain competitive salaries to attract and retain top talent in critical areas. Any organization that has adequate resources to maintain the salary ranges as well as fund the potential increase in overall costs based on the possibility of paying some employees at higher levels of the market is a candidate for using market-based structures. Examples include investment and financial service companies, pharmaceutical companies, professional services or any other organizations desiring to win the war for talent, in part by removing some of the restrictions surrounding pay levels, and meeting or exceeding market levels of pay for skills critical to the organization’s success.

Step Structures

Design Characteristics

Step salary structures typically employ the same range spreads and midpoint progressions as traditional structures (20 percent to 40 percent, and 5 percent to 10 percent, respectively) and essentially have a minimum (the first step), midpoint and maximum (the top step). Unlike traditional structures, however, the salary grades or ranges of step structures are divided into equal steps, either by absolute dollar amounts or a constant percentage progression to the top step. Guidelines typically accompany step structures that provide consistency around the step at which a new employee should be brought in and that allows an employee to progress to the next step. Although it is often assumed that progression to the next step is an automatic event, many step structures have requirements such as meeting certain threshold performance levels. (See Figure 5.)

Advantages

A compensation program with a step structure can be fairly easy to administer and automate because employees progress through the ranges predictably, usually moving from step to step each year. Determining the amount of a merit increase is eliminated, as the progression to the next step determines the amount that the employee will receive. Compensation costs are very predictable and controlled, eliminating most surprises at least attributable to merit increase expenses.

Disadvantages

Step structures also bring a significant disadvantage, which has largely led to their limited use in many organizations. The fixed nature of the steps and guidelines that often accompany the structures give managers little ability to truly reflect performance in the increases received by employees. This single aspect of the step structure is so at odds with the pay for performance strategy of most organizations that many do not even consider step structures today.

Organizations Best Suited for Step Structures

Step structures may make sense for some organizations, even in today's "pay for performance culture." For some organizations with very limited merit budgets, making a distinction that adequately reflects differing levels of performance is almost impossible. A step structure can simplify the process of determining merit increase amounts, which may not be adding that much value to the organization anyway due to the limited funds available. The step approach also may allow the focus of the performance evaluation to be on improving performance and giving performance feedback, rather than on the rating and subsequent merit increase that a manager wants to give an employee. Industries where step structures are still commonly used include health care, education, the public sector and some not-for-profits.

The Future of Salary Structures

It is yet to be seen if the next decade will produce as many new approaches and experiments to designing and developing salary structures as the previous decade. However, as long as human capital continues to gain prominence as one of the key requirements for organizational success and dominance in any industry, innovative compensation and human resources approaches will be desirable and necessary.

Due to the desire for flexibility and the need to reward talent, salary structures likely will continue to evolve from rigid, internally focused tools to more flexible, market-based designs. It will continue to be imperative for talented, strategic compensation and HR professionals to consult with their client organizations, consider various alternatives, design and champion new programs and, in turn, contribute to the bottom-line achievement of the organization's overall goals and objectives.

Glossary of Terms

Salary Range or Grade -- A range of pay rates, typically defined by a minimum, midpoint and maximum, which reflect jobs having a similar internal or external (market) value.

Salary Structure -- A series of salary ranges which encompass a family of jobs or the entire universe of jobs within an organization.

Midpoint Progression -- The percentage increase in the midpoint from one salary grade to the next, expressed as a percentage of the lower midpoint.

Range Spread -- The distance from the salary grade minimum to the salary grade maximum, typically expressed as a percentage.

Midpoint -- The salary level midway between the minimum and maximum of a salary range, sometimes used as a reference for the market value of jobs in the grade.

Range Overlap -- The degree to which adjacent salary ranges or grades in a given salary structure encompass the same pay levels.

The Author

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FIGURE 1 Traditional Salary Range

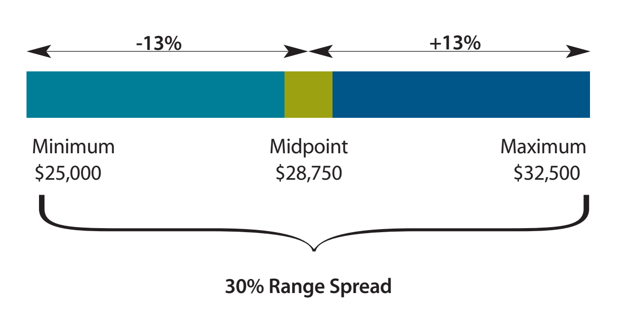

FIGURE 2 Broadband Without Pay Zones

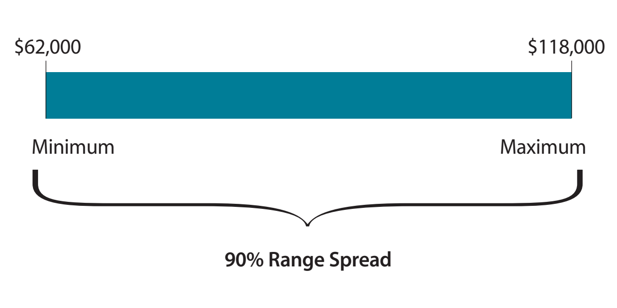

FIGURE 3 Broadband With Pay Zones

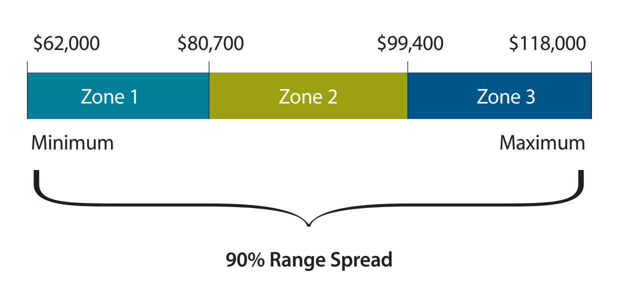

FIGURE 4 **Market-based Salary Range**

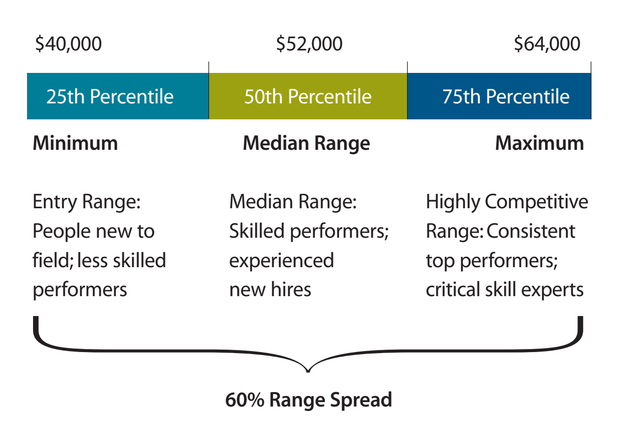

FIGURE 5 **Step Salary Range with Ten Steps**