

# COMPENSATION MANAGEMENT

## HRM3705

### Study unit 8

**Building pay structures that recognise  
employee contributions**

# Learning outcomes of study unit 8

Once you have completed study unit 8, you should be able to:

- Discuss the steps in constructing a pay structure
- Explain the difference between Broad banding and two-tier pay structures
- Discuss merit pay system structures
- Design a merit grid guideline for a company
- Define and determine the pay policy line
- Critically discuss Broad banding
- Design a basic pay structure
- Contrast between red circle and green circle pay and identify when these situations may
- Calculate pay ranges, and midpoint values for a specific pay grade

# Definitions

Concept	Definition
<b>Pay structure</b>	The pay structure refers to the pay scales attached to grades and the way in which these scales are structured; their range, their slope, overlap, differentials and market positioning
<b>Pay slopes</b>	The steepness or angel of the pay curve The percentage difference between the pay for one grade and another. Provides a useful tool for measuring and comparing pay slopes. A pay slope of 15 – 20% between pay grades is generally appropriate for most circumstances (Swanepoel, Erasmus & Schenk, 2008:97)
<b>Pay ranges</b>	The pay range refers to the width of the pay scale, i.e. the distance between minimum and maximum pay for each grade. It is usually measured in terms of the percentage above and below each midpoint
<b>Pay overlap</b>	The extent to which the maximum of the lower grade overlaps with the minimum of the next higher grade. It is dependent on both the pay range and pay slope
<b>Pay ratio</b>	The ration between the CEO's pay and the lowest pay. The highest salary divided by the lowest salary

# Constructing a pay structure



Pay structures are the array of pay rates for different jobs within a single organisation; they focus attention on differential compensation paid for work of unequal worth. The number of levels, the differentials in pay between the levels, and the criteria used to determine those differences describe the structure

## Example of a pay structure

Grade	Annual Total Package				
	10 <sup>th</sup> Percentile	25 <sup>th</sup> Percentile	50 <sup>th</sup> Percentile	75 <sup>th</sup> Percentile	90 <sup>th</sup> Percentile
A	R38 418	R42 927	R52 630	R57 984	R64 609
B	R61 104	R72 216	R90 079	R118 044	R142 536
C	R146 849	R170 644	R215 547	R265 587	R317 721
D	R324 043	R390 699	R481 780	R602 919	719 495
E	R700 364	R803 317	R922 681	R1 076 679	R1 272 038
F	R1 428 000	R1 661 581	R2 069 975	R3 000 000	R4 631 602

# Pay Structure (Continue)

**Purpose:** To provide guidelines on which grade employees are on and provides a framework on which remuneration decisions and application thereof are made

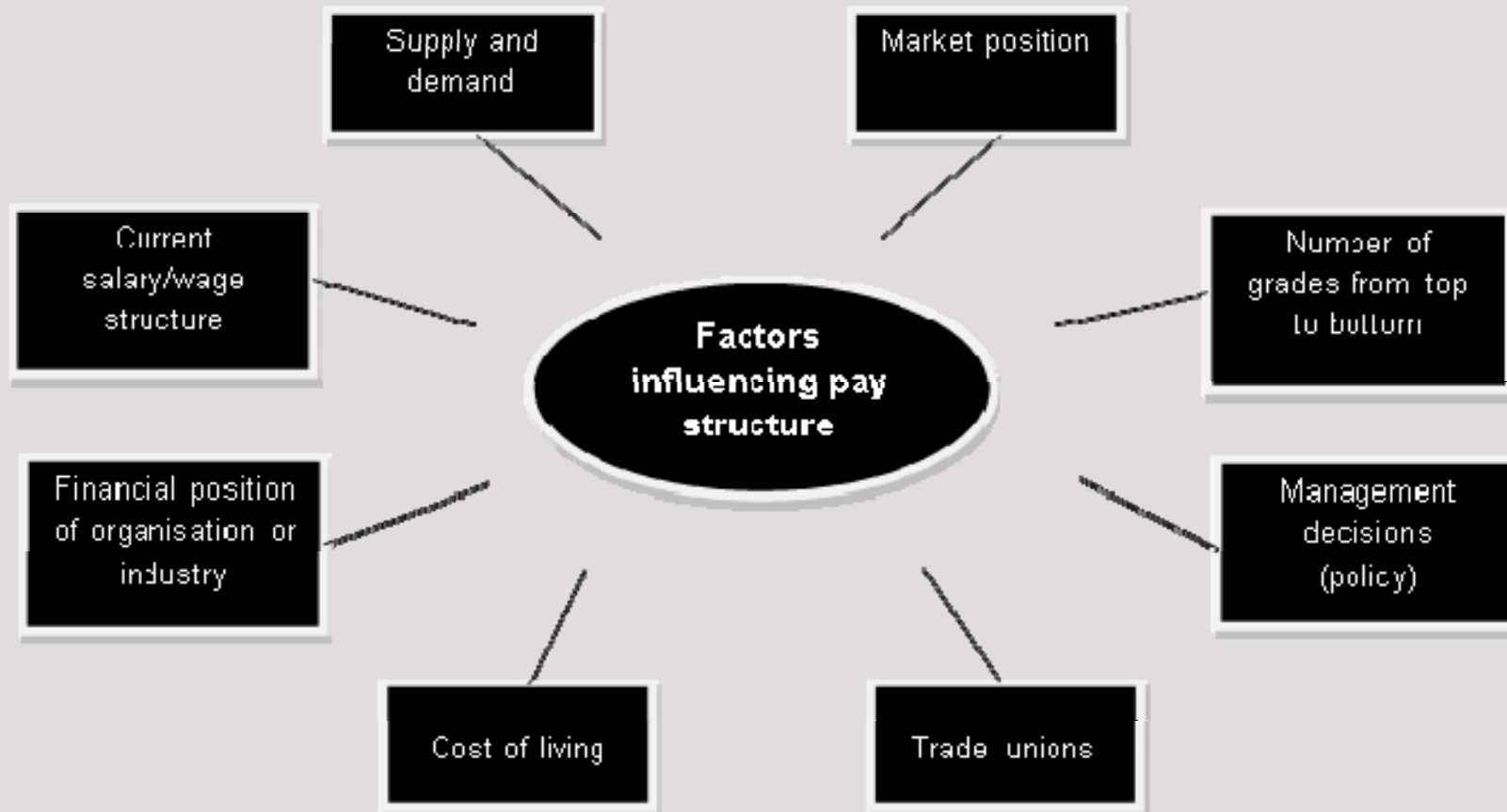
<b>Base remuneration decision</b>	<b>Application</b>
Recruitment	Managers can grade the job and offer a salary in the pay range (according to the remuneration policy)
Performance	Employees who demonstrate sustained superior performance could move through the pay scales quicker
Competence and skill demonstration	More and more organisation remuneration policies allow individuals who apply relevant competence and skill to move up the pay scales quicker
Contribution	Paying for contribution is a major trend which should be reflected in all leading companies' remuneration policy
Business needs or scarcity of skill	The business imperative is particularly applicable in Africa during transformation of companies. This together with scarcity of some skills sometimes leads to "anomalies" in the pay structure, but these are defensible.

# Criteria for pay structures

Pay structures should (Armstrong: 1999):

- Be appropriate to the characteristics and needs of the organisation and its employees
- Facilitate the management of relativities and the achievement of equity, fairness and consistency in managing employee reward
- Be capable of adapting to pressures arising from market-rate changes and skills shortages
- Facilitate operational flexibility and continuous development
- Provide scope as required for rewarding performance and increases in skill and competence
- Clarify reward and career opportunities
- Enable the organisation to exercise control over the implementation of pay policies and budgets

# Design of pay structure is influence by:



# Constructing a pay structure

## Five Steps

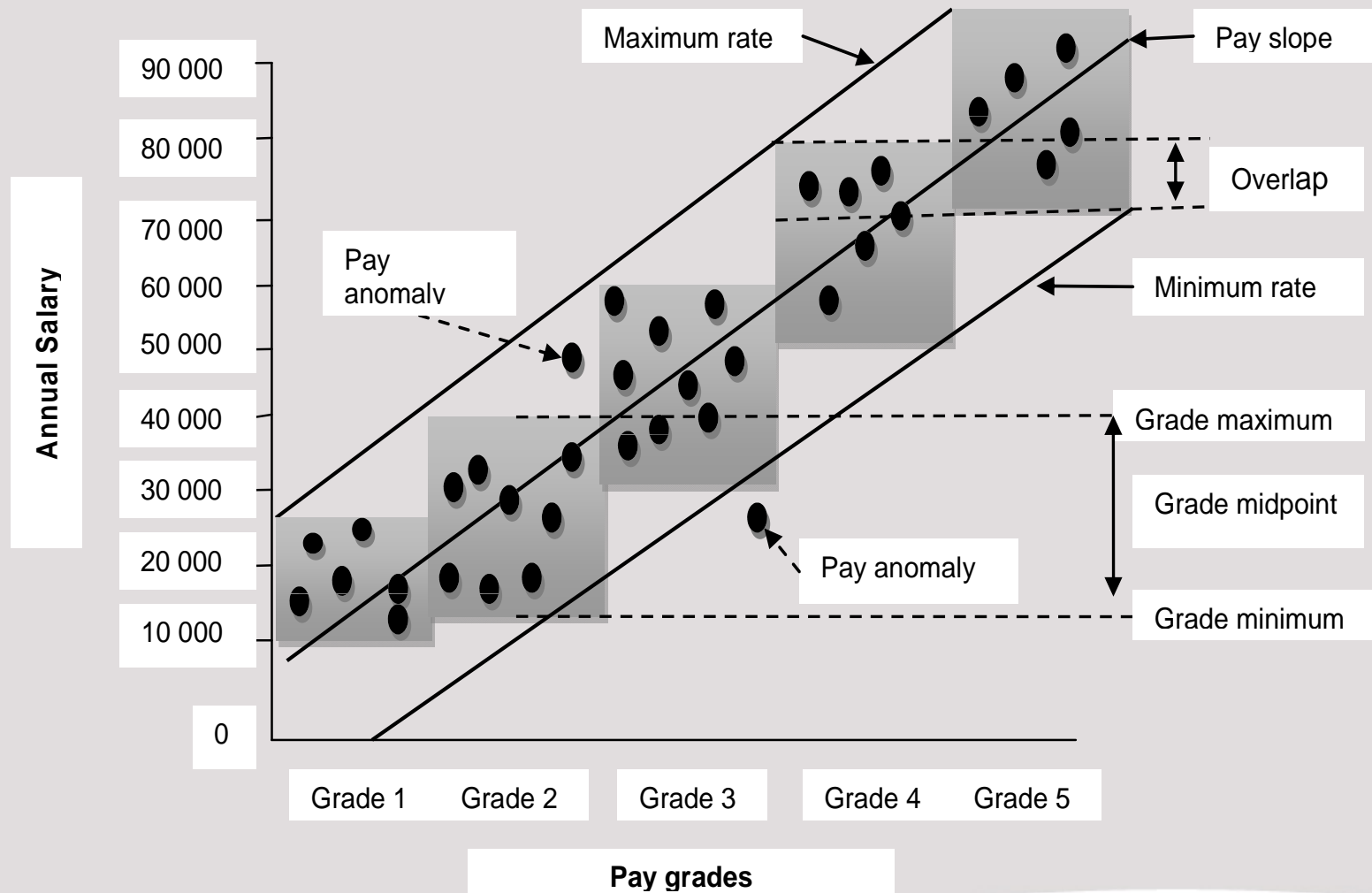
- Decide how many pay structures to construct
- Determine a market pay line
- Define pay grades
- Calculate pay ranges
- Evaluate results



# Common pay structures

- **Based on job families**—executive, managerial, professional, technical, clerical, and craft represent distinct job families
- **Based on geography**—companies with multiple, geographically dispersed locations such as sales offices, manufacturing plants, service centers, and corporate offices
- **Conventional pay structures** – a sequence of job grades into which jobs with broadly equivalent value are slotted. A range is attached to each

# A basic graded pay structure



## Some more definitions

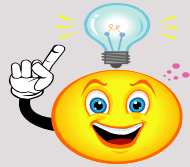
- **Pay slope:** The angle or steepness of the pay curve
- **Pay grade overlap:** The extent to which the minimum pay of the higher pay grade is overlapped by the maximum pay of the lower grade
- **Grade drift:** Process whereby jobs may be re-graded, and so migrated up a graded pay structure, without any significant change in the content thereof
- **Pay grade:** The percentage increase between the lowest and the highest points in the range
- **Pay ranges:** Indicates the minimum and maximum rates payable for any job in the grade

# Advantages and disadvantages of grade structures

Advantages	Disadvantages
<ul style="list-style-type: none"><li>• <b>Clearly indicate pay relativities</b></li><li>• <b>Provide a framework for managing relativities and for ensuring that jobs of equal value are paid equally</b></li><li>• <b>Allow better control over the fixing of rates of pay and pay progression</b></li><li>• <b>Are easy to explain to employees</b></li></ul>	<ul style="list-style-type: none"><li>• Defining grade boundaries is a matter of judgement which may not always be easy to defend</li><li>• If there are too many grades, there will be constant pressure for upgrading, leading to grade drift (unjustifiable upgrading)</li><li>• Pay ranges create the expectation that everyone is entitled to reach the top of the scale</li><li>• Graded structures can create or maintain hierarchical rigidity which is at odds with the requirement of flexibility in new team- and process-based organisations</li></ul>

# Calculation of pay range

$$\frac{\text{Maximum} - \text{minimum}}{\text{Minimum}} = \text{Total}$$



## Example: Calculation of pay range

Minimum salary – R60 000

Maximum salary – R90 000

$$\frac{90\ 000 - 60\ 000}{60\ 000} = 50\%$$

# Calculation of midpoint spread

$\frac{\text{Midpoint} - \text{Minimum}}{\text{Minimum}}$       and       $\frac{\text{Maximum} - \text{Midpoint}}{\text{Midpoint}}$



## Example: Midpoint spread

In this example, the maximum is R100, 300, the minimum R66, 800 and therefore the midpoint is R83, 550. The spread on either point of the midpoint is therefore calculated as follows:

$$\frac{R83\ 550 - R66\ 800}{R83\ 550} = 20\% \text{ of midpoint}$$

$$\frac{R100\ 300 - R83\ 550}{R83\ 550} = +20\% \text{ of midpoint}$$

*Typical ranges spreads in Africa*

Percentage spread	Typical jobs
20 – 40%	Lower level service, production and maintenance
30 – 50%	Clerical, technical, specialist
40 – 60%	Higher level professional, middle management
60% and over	Higher level managerial, executive and expert technical

# Pay Compression

- **Pay compression:** Where highly capable employees are paid similar to employees with less skill and experience
- When pay spread is small
- Threatens competitive advantages
- Caused by:
  - Failure to raise pay range limits
  - Scarcity of qualified applicants

# Pay compression continue

- **Green circle pay rates:** Where an employee's salary fall below the minimum
- **Red circle pay rates:** Salary falls above the maximum



# Compa-Ratios

- Evaluates pay structures
- Index competitiveness of internal pay rates based on midpoints
- Divide pay rates by midpoint
- Compa-ratio meanings
  - 1 = market match rate
  - $< 1$  = market lag rate
  - $> 1$  = market lead rate

# Merit Pay systems

## Considerations

- Communicate link between pay and performance
- Use effective appraisal methods
- Establish increase amounts and types
- Settle on base pay level

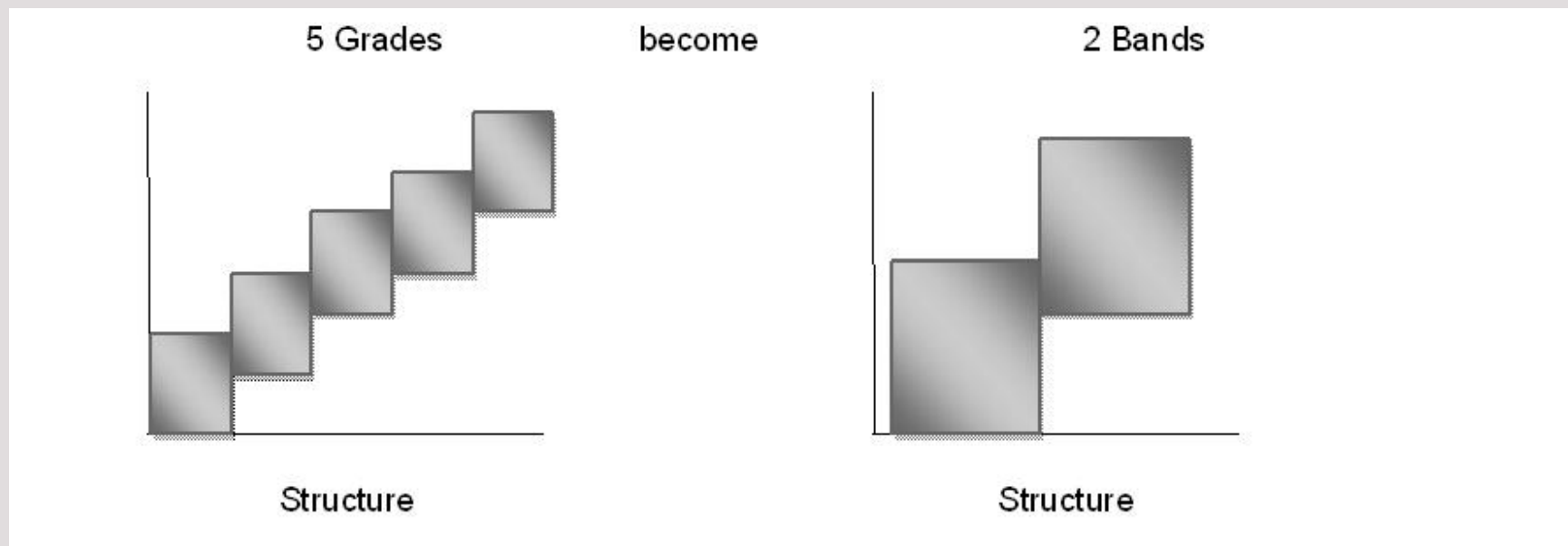
# Merit Increase amounts

- Reflects prior job performance levels
- Needs to motivate
- Needs to be meaningful
- Influenced by the cost-of-living
- Indexed as a percentage of budget
- Companies typically take one of two approaches in **timing of pay raises**:
  - Common review date or common review period
  - Employee's anniversary date

# Broad-Banding

- **Definition:** The collapsing of job clusters or tiers of positions into a few wide bands to manage career growth and deliver pay
- Consolidates pay grades and ranges
- Flattens corporate hierarchies
- Emphasizes teamwork
- Broadens job duties and responsibilities
- Promotes quicker decision making
- More latitude in pay rate decisions
- Broad-banding was created to achieve the following objectives:
  - Develop broader work force skills
  - Encourage career development among employees
  - Reduce administration with job evaluation, salary structure and merit pay

# Graphic presentation of Broad-Bands



Prepared by Magda  
Bezuidenhout, Adapted from

# Reasons for implementing broad-banding

Goal	Specifics
Improve competitive advantages	Broadbands enable the company to break down the conventional hierarchy and thus to promote the characteristics of their smaller competitors, namely: speed, adaptability, creativity, increased employee involvement, willingness to embrace risk
Support a new climate/culture	Bands support cultures that promote contemporary values: employees are focused outside the company to their customer based and the competitive challenges of the market
Support delayering initiatives	Reducing the number of job levels increases spans of control and decreases direct supervision. The result is that detail-oriented conventional salary administration will change
Suggest new ways of integrating activities	Less structures firms are likely to view work as a process that can be performed by process teams that work laterally through the organisation rather than functional teams that work vertically
Promote a broad view of work	Broadbands provide employees with the opportunity to create their own jobs. The focus is thus on value-add. Employees become less focused on grade and getting the job done and more focused on identifying the critical needs of the organisation and trying to ensure that these needs get met
De-emphasise a "ladder" view of career development	Broadbands provide the opportunity for employees to use the whole organisation for their development opportunities. Employees no longer have to concentrate simply on advancing within their functional areas because they can pursue lateral, cross-functional development opportunities that help them create their own impact on the firm

# Two-tier compensation structure

- New employees paid less
- Temporary or permanent rewards
- Mainly in unionized companies
- May hinder recruiting
- Can lower employees' morale

**END OF STUDY UNIT 8**  
(Refer to the study guide for more  
detailed discussions on the topics  
presented here)