What Causes Pay Compression

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Pay compression occurs when pay disparities between workers with different skill sets and experience levels are insignificant. It frequently occurs when current employee pay raises do not keep pace with market wage increases, resulting in new workers being hired at levels comparable to those who have worked for the company for many years.

Pay compression can also happen when there is a misalignment between how the pay system is intended and how it works in practice. On paper, if a sales team has a high amount of at-risk pay only awarded when specific goals are fulfilled, this should result in pay variation, with those with the most expertise and talent being paid more than those with less. However, depending on the team member's skill level and years of experience, these incentive pay schemes may not result in much pay variation. This may be a sort of wage compression

Pay compression affects both managers and their direct reports. Most people believe that managers are paid more than the employees they supervise. However, this may not be the case if your firm suffers from pay compression.

Employee disengagement, turnover, and even lawsuits can all result from pay compression. Suppose your employees complain that the only option to receive a raise at your firm is to threaten to quit. In that case, you probably have a pay compression issue. You're probably also at risk of fleeing.

Why is pay compression a problem?

If employees believe they are being undervalued, pay compression can lead to turnover. This is more likely to occur if long-term employees realize that they are being paid less than new hires.

What Causes Pay Compression?

There are a couple of main causes of pay compression.

1.

Demand Exceeds Supply

Pay compression may occur when skills supply and demand imbalances. This is when the demand for a certain skillset outnumbers the supply. In other words, pay compression occurs when companies raise salaries to entice new personnel while ignoring market salary increases for current or tenured employees. Data Scientists and software engineers are two examples of jobs in such high demand.

2.

Stale or outdated data

Pay compression arises if your internal compensation system becomes stale and no longer synced with external market data. This could be due to a lack of market analysis or dependence on old compensation data from internal spreadsheets to inform pay decisions.

Minimum wage rises can also cause pay compression, as employees with less experience receive a raise while those with more experience remain at their existing levels. When the minimum wage is raised, every employee in the company should receive a proportionate wage increase.

3.

Broad pay grades

Pay compression can also occur if you have two or three tiers of accountants, software developers, or data scientists but just one pay range for all of them. In this instance, having distinct pay ranges for each level of job proficiency and promoting employees to the next tier as they reach a new degree of experience and responsibility is the best option. You might also give those employees a sense of stagnation in their careers, leading them to explore opportunities outside of your company.

4.

Promotional techniques that aren't up to par

Some promotion practices create pay compression problems. For instance, if a long-serving employee gets promoted, they will be given additional tasks, including leadership responsibilities. However, the employee is paid less than a direct report or a new hire in a similar position despite the promotion. That creates pay compression problems.

Due to the economic downturn, many pay increases were frozen. New hires or candidates may want better pay after the economy improves, outpacing the stagnant salary of existing employees.

How can Pay Compression be addressed?

One of the most vexing pay challenges that compensation experts must deal with is pay compression. It's usually a lose-lose situation, and the options for dealing with it are limited.

Many corporations in a down economy rely on existing high unemployment rates as their de facto retention strategy. If you haven't solved pay compression issues, your greatest performers, not your middling or troublesome ones, will flee to your competition once the economy improves. Some people will not wait for the economy to improve.

Those who do not flee may lose interest in giving their finest performance. They might argue that if you're paying them the bare minimum to keep them, they owe you the bare minimum in terms of effort to do the job you're paying them to do.

So how do you deal with it?

1.

   ### Resolve pay inequities

The obvious solution is to pay employees what they're worth by eliminating pay inequalities and implementing merit and market increases across the board, or at least for your most important positions. This would necessitate allocating funds for pay raises in all areas where pay disparities exist. If your response is, "But we can't afford that!" you should think about how much it would cost to replace all of the employees who would be affected if your underpaid staff left. It would help if you also considered the additional costs associated with the hiring process and the loss of production that occurs while positions are vacant.

2.

Make a plan

Suppose you're having trouble with pay compression because finances are scarce. In that case, you may at least devise a strategy for adjusting compensation when conditions improve and invest in better pay communications to communicate this strategy. Inform your staff about the issue, or teach managers to do so, and provide some criteria for enacting pay rises if the situation changes. When those conditions are met, keep your word. If you commit to solving pay compression issues, you must implement market changes as soon as your company can afford to do so. Going back on your word, or even just delaying action, will destroy employees' trust in HR and reduce their desire to stay with the organization.

3.

Consider variable or incentive pay

In the meantime, you might wonder what else, except pay, could boost staff morale and ensure employee loyalty. Employees may be astonished at what they will give up in exchange for wage raises, at least temporarily. Mentoring or development opportunities, a more flexible work schedule, the opportunity to work from home, or paid time off to volunteer are all possibilities. Experiment with your options with a lot of imagination.

Instead of base pay increases, you might want to consider variable or incentive pay. For non-commission employees, for example, you may be able to award bonuses for exceptional performance, particularly performance connected to new revenue or renewals. Although this will not cure the pay compression problem, it will boost morale, increase productivity, and restore faith in your ability to address pay compression and pay unfairness as quickly as feasible.

4.

Address the compensation budget with finance

Finally, you should identify ways to engage with the finance staff on market adjustments, pay equity corrections, and bonus incentives. Suppose compensation difficulties are driving the company to lose high performers. In that case, it's vital to solve them, and the money may be found elsewhere if you work with the finance team on budget allocation. It's also common for HR to collaborate closely with finance on compensation structures. Educating the finance team on the fundamentals of compensation management can go a long way toward alleviating constraints, particularly during a downturn.

How to Fix Pay Compression in your company

Pay compression is a big problem with no easy solution. However, employers or HR Professionals can take steps to first assess what pay rates are more suitable and then work toward better pay fairness. Here are some things you can do to get back on track:

1. Examine the pay structure in detail to determine where contradictions exist. Examine any places where wage disparities are incompatible with the company's structure.
2. Compare pay levels to the company's overarching vision and goals, and determine what needs to be changed to bring pay levels back into line with those objectives.
3. Compare in-house compensation to market pay for similar occupations to see where there are differences.
4. Rethink how you're going to employ incentives and at-risk pay. As previously stated, at-risk pay may contribute to pay compression because the at-risk amount may fluctuate greatly (creating the perception of pay variations on paper), but the actual amount paid may not. This happens when the at-risk pay is too easy to obtain, practically everyone receiving the full amount and no fluctuation. It can also happen if the at-risk component is too difficult to acquire, resulting in a situation where many employees are only paid the basic rate and the at-risk portion is useless.
5. Examine how job descriptions have changed over time and whether or not compensation increases have kept pace with changes in responsibilities.
6. Examine whether any inequalities appear discriminatory and have developed over time, such as pay disparities between men and women.
7. Work out a plan to align employee pay and benefits with the market and corporate goals after analysing the full pay structure. It's possible that putting this idea into action will take some time. Once the problem has been resolved, make efforts to avoid future pay compression by keeping track of market pay rates and retaining current employees at suitable levels.

How to Prevent Pay Compression

The most effective strategy to deal with wage compression is to avoid it in the first place. Pay compression can be avoided if you are knowledgeable about compensation planning and use contemporary software and tools for compensation administration.

If you want to avoid wage compression, plan and anticipate your future hiring demands. Keep an eye on market changes for your essential positions by reading market surveys or consulting other compensation data (such as IPC), and alter your pay ranges as needed.

When it comes to raises for current employees, don't fall back on three percent yearly basic pay increases distributed uniformly across the entire workforce. You should consider how much your key positions are worth on the market, how minimum wage or inflation has affected certain locations, whether there is inequity in how employees are compensated for the same job, whether job descriptions have changed, and how individuals have performed in their roles. Compensation should be modified accordingly or to the extent that your budget allows.

Although annual modifications are sufficient, your recruiting staff can provide early input on roles that are moving faster in the market if you need to make more regular adjustments.

How to calculate pay compression

You can make use of the Coefficient of Variation to determine pay compression. To do that, you can follow the following steps;

1. Calculate the mean or average salary of each employee in a specific grade or level.
2. Calculate the standard deviation for each grade or employment level by subtracting the mean salary for the salary of each salary point.
3. Divide the standard deviation and the average salary for each respective grade or group of employees.
4. Convert the ratio obtained in step 3 into a percentile.
5. A smaller CV could indicate pay compression or no differentiation based on performance.

To monitor the severity of salary compression, most firms should conduct an annual analysis. Those with more serious problems, such as compression or high turnover rates, or who hire frequently may need to undertake an analysis every six months.

In the end, companies that adopt a proactive approach to pay compression and pay disparity, especially with corresponding pay transparency and pay communications, are more likely to attract top personnel. Competitive compensation across the board is a major selling feature for any employer brand, resulting in the most qualified prospects and the most engaged and productive employees.

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