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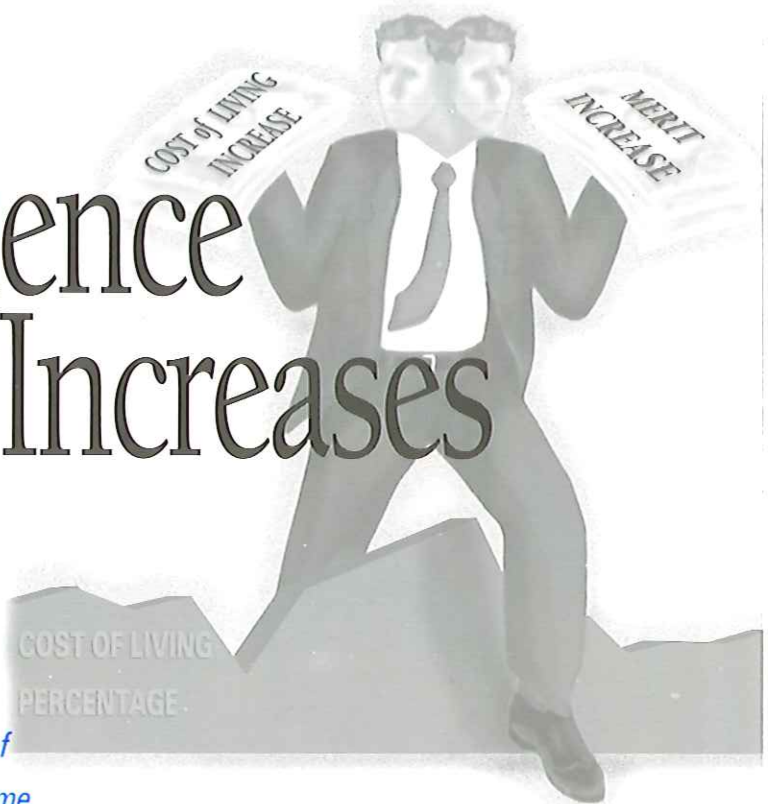
The Art & Science of Pay Increases



by Edmund B. Ura, President, Management Resource Center, Inc., Troy

How do you reward your employees for a job well done? Do your top producers earn a higher percentage raise than those who are "just doing the minimum?" Does improvement of skills or additional responsibilities come into play when evaluating employees' amount of pay increase? What does your company do to stay competitive in the area of compensation?

Every year, employers face the burning question of how to adjust pay. For most employers, regardless of the time period when increases are actually given, the decision point for determining pay increases is during the budget development phase for the upcoming fiscal year. For most companies, this means the fall. While business publications and consulting firms advocate new, innovative ways of paying employees, the majority of manufacturers continue, year after year, to use the same approach they have always used. While employers come up with an answer to the question of "how much," they rarely consider the "how" or "why" associated with determining pay increases.

Management Resource Center, Inc. (MRC) is an independent consulting firm offering business and compensation strategies along with planning, research services, and management consulting. MRC conducts the research for MMA's cash compensation survey, executive compensation survey and employee benefits survey.

Setting Pay Levels

Most employers establish a "budget" for payroll, or for some type of increase to current employees, and then determine a method of distributing it among their employees. Before considering how employers come up with this amount, it is worth examining whether this method of setting pay levels is rational.

The establishment of payroll budgets is often based on arbitrary figures from either competitive studies, or the company's "ability to pay"–not on the cost of the labor itself. Human resources is one of the few areas where the amount of increase in the real cost of resources is often ignored in favor of what "seems reasonable" or is based on what other organizations are doing. Also, reliance on statistics that are representative of the labor market as a whole (not on the actual, specific market in which an employer competes for talent) causes the risk of having a dysfunctional pay program that does not meet either the employers' or employees' needs.

A parallel situation in resource acquisition–raw materials purchasing–points out an underlying fallacy in the way many employers set pay overall levels. In most manufacturing firms, purchasing departments are asked to provide estimates of the costs of raw materials during the coming year and what their suppliers tell them these costs will be. They determine the total cost of raw materials based on their "per-unit" costs and the production estimates made by the company. Consider the quandary, however, of the purchasing manager who is told by his or her employer that the amount the company will spend on raw materials is not dependent on the price set by the suppliers. Instead, it is contingent upon three things:

1) how much other companies will increase their payments to suppliers;
2) the amount the company feels is a "fair" price increase; or,

3) some arbitrary government index that has little or nothing to do with the actual cost of the raw materials.

The simple solution? Treat "human" resources just like any other resource. Identify the value of each "unit" based on its performance, and supply and demand factors. Add the value/cost of all necessary "units" for operation of the business. Then add to this total, the price of all the costs necessary to support the units (FICA, insurance premiums, etc.). Present this cost to the budget process as any other resource acquisition would be done.

Considering that most employers will continue to use the method of "setting an amount and divvying it up," it is important that the process for determining the increase budget be tied as closely as possible to actual labor market conditions.

The Cost of Living

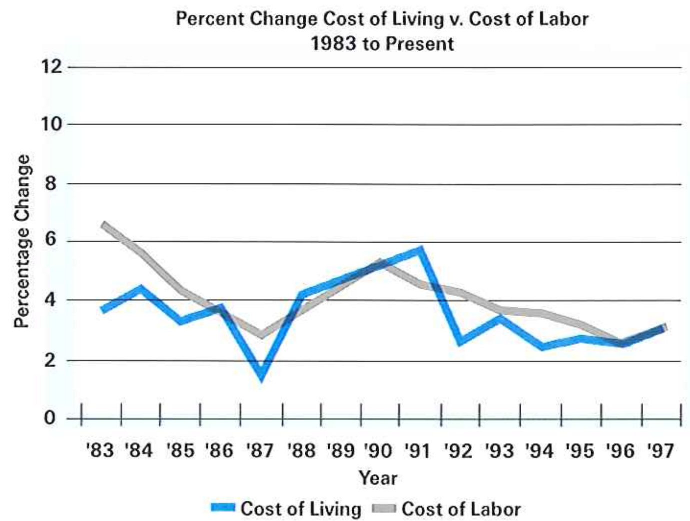
Of all the methods used to determine pay increases, "cost of living" (COL) is perhaps the most popular, but least understood–and the least tied to actual business strategies. Printed monthly in the newspapers and used as an automatic feature for pay adjustments in many industries, the COL is purportedly expressed by the change in the Consumer Price Index (CPI), a statistic calculated by the federal government Bureau of Labor Statistics. The CPI measures the cost of a "market basket" of goods and services purchased by consumers at various income levels. *The cost of living, however, does not relate to actual income in any way.*

The use of the CPI has been institutionalized in labor agreements in some industries (e.g., the automobile industry and the UAW) as a means of "keeping employees' pay whole," so that their ability to buy goods and services is not reduced. It is perceived as fair because it maintains an employee's position in society. Because pay based on the CPI does *not* "advance" pay status relative to others, it is also seen by many as inadequate, and other increases are also required.

The cost-of-living type of increase is very popular among employers, particularly in a production environment. The advantages of such an approach include:

- since the statistic is produced by the government–a third party that theoretically has no side in the battle between employers, employees and organized labor–the statistic itself is viewed as objective;
- it measures something that employees can grasp, tied directly to them and their lifestyle; and,
- it allows employers to give a "fair" increase, and feel that they are keeping their employees whole.

There are several major concerns with this approach, however:



- the statistic is not "relevant" for business purposes, since it does not relate to any real change in the cost of labor to business;
- the statistic may *not* be accurate, according to the Bureau of Labor Statistics; and,
- the "cost of living," while relatively consistent over the last several years, can fluctuate wildly. In the 1970s, when inflation ran at double digit rates, companies with locked-in COL adjustments saw labor costs increase dramatically. When inflation and high unemployment coincide, a vicious cycle takes place: prices rise, causing pay to increase, and causing further increases in prices to a market with fewer purchasers (due to layoffs caused by the increases in labor costs). All of this effect, but none caused by the actual cost of the employees' labor itself.

The trend among employers who have institutionalized COL as a method for determining increases is to separate the two. Generally speaking, the COL is *not* seen as a valid measure of labor costs, nor as an effective way of assuring that pay is competitive. The usefulness of the statistic is best seen in comparing how actual company policy relates to the cost of living.

The Cost of Labor

A frequently overlooked statistic, also provided by the government, is the cost of labor–a business-oriented statistic that measures all of the costs associated with employment. This index measures compensation, benefits costs, and other costs associated with employment. The statistic is somewhat comparable to other statistics measuring the prices of raw materials. The compensation component of the cost of labor is useful in determining the amount by which total payroll costs should increase. It is most useful where the employee population of an organization resembles the population of the labor market–that is, the demographics of the workforce are comparable, with turnover, retirement age, experience and other factors being similar.

For the organization whose employee population is a reasonable sample of the workforce as a whole, the cost of labor provides a method of rationally setting a payroll budget. The advantages of this method are delineated below:

- setting budgets, according to the actual cost of labor, is a more appropriate business strategy;
- setting payroll based on these costs is more likely to maintain competitive pricing, at least with respect to labor costs; and,
- payroll should remain competitive over the long term as well as short term.

The disadvantages of this method are that:

- it is less easily understood by employees, and it does not relate to their own purchasing power;
- it does not assure that increase programs will be competitive either in the local labor market, or in an industry where employees have opportunities to seek new employment; and,
- it *may* have an effect of causing an erosion of purchasing power. This diminution of purchasing power, however, may not actually occur if the CPI has consistently overstated increases in real consumer costs as the government has alluded.

Overall Pay Movement

A common statistic provided by the government and various research organizations is the overall average increase in pay among employees in the labor market. The key to the use of such statistics is in understanding exactly what they represent. Different methods for measuring overall pay movement call for different approaches. Note the following two methods.

- A "constant sample" of pay increases to individual employees from year to year is very useful for determining what an individual employee's increase should be. It will not, however, be useful for budgeting. The cost of payroll overall from year to year will nearly always be less than the average increase, because retirement and other turnover typically results in the departure of higher-paid employees and the acquisition of lower-paid employees from the workforce. Therefore, setting an overall payroll budget based on a constant sample will result in an overall budget greater than necessary to maintain competitiveness. It is, however, an effective way of ensuring that overall, individual employees' pay increases will be competitive.
- An "overall average" pay movement statistic that measures the change in pay for the "average" employee will be similar to the cost of labor statistics discussed above. As noted, this type of statistic is effective for determining the overall cost of payroll, or for adjusting programs (e.g., salary structures). Setting the actual amount of pay increases for employees based on this type of statistic will typically *not* provide an adequate increase to maintain competitiveness.

Merit Budgets

One of the most common measures of the competitiveness of a pay increase program is comparison to other companies' merit budgets. The "merit budget" is the amount that a company allocates to increases granted in recognition of employees' performance during the past year. The budget is typically set in one of two ways:

1) The company selects a budget amount, as a percent of payroll, either based on its ability to absorb increased costs, or by following industry trends. Once the budget is established, the company sets a strategy for distributing the budget amount among employees, based on factors such as their current pay and performance.
2) The company sets a target increase amount for employees with various levels of performance, or current pay, determines the "cost" of such an approach, and decides whether it can absorb the cost.

While merit budgeting is one of the most common methods for assessing the competitiveness of a compensation program, comparison of merit budgets is least likely to provide an adequate understanding of whether a company's compensation program provides competitive pay. This measure only assesses the actual total cost of providing increases to existing employees. It does *not* provide an accurate measure of the average increase given to employees, or the average increase in payroll costs.

Recommended Strategy

In conclusion, one of the most effective methods for determining the cost of payroll for the upcoming year is to:

- assess the appropriate increase to be given to each employee (based on average pay levels reported in surveys, the employees' performance, and/or other factors considered important to the employer); and,
- project new employees' pay and the replacement costs for retirees and other employees expected to turnover in the coming year.

Establish the total amount of payroll based on these projections; the difference between this year and last year provides the increase to work with.

Whatever method is chosen, it is important for manufacturers to accurately determine their labor market and ensure that their pay increase program remains competitive, especially in light of today's shrinking pool of skilled workers.