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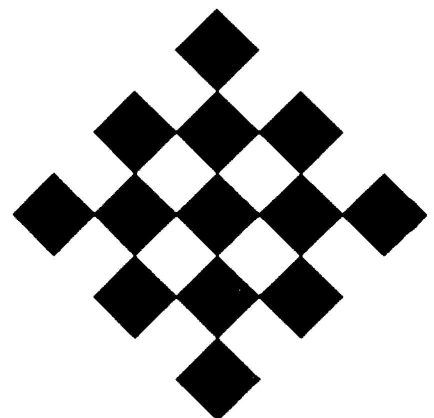

A PANEL PUBLICATION

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B*ase salary increase budgets are typically influenced by annual company performance, and individual increases are reflective of employee performance over the year. Should companies continue to escalate their permanent fixed salary costs based on a single year's performance?*

This article outlines a program that breaks the annual merit increase into two components: (1) a base salary increase that recognizes experiences, contributions or events that improve the employee's ability to contribute in the future and (2) a one-time merit bonus that rewards the employee's successes and contributions over the past year. Such a program will help companies reduce fixed pay, tie compensation levels to the ability to pay, reward employee development, and provide greater recognition for outstanding performance.

Suppose an individual is earning $35,000 a year and is a solid contributor over a ten-year period. Under a traditional salary increase program, the individual would probably be rewarded with base salary increases between 4 percent and 7 percent a year (see example at top of next page). This would have the effect of increasing base salary to $55,850 by the year 2002.

Now let's examine the impact of the two-component approach. While the individual's annual performance varied somewhat over the ten-year period, let's assume that the expected contribution for the individual remained approximately the same. That is, some years the individual exceeded expectations, and some years he or she fell a little short, but the individual did nothing to alter the basic expectation level. Because the expected contribution did not change, the company could (1) give no salary increase or (2) give a modest increase designed to maintain the employee's relative position in his or her salary range. Thus, if the salary range is adjusted by 3.5 percent, the employee would receive a 3.5 percent base salary increase to keep him or her at, for example, 97 percent of the midpoint. For purposes of the example, let's assume that the employee's salary is adjusted only by the salary range movement, but that the employee is additionally rewarded with a merit bonus that is reflective of his or her annual performance. Base salary will advance from $35,000 to $47,701 over the ten-year period (3.5 percent each year). In addition, the individual will receive annual merit bonuses ranging from 4 percent to 10 percent a year.

Under the two-component program, the individual receives both a base salary increase and a merit bonus each year. In the *leanest* year, the individual receives a 3.5 percent base salary increase *and* a 4 percent merit bonus, rewards totalling 7.5 percent of base salary. Conversely, under the traditional pro-

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Table 1: Traditional Program Compared to Merit Bonus Program

	TRADITIONAL PROGRAM			TWO-COMPONENT PROGRAM			
Year	*Base Salary*	*Annual Increase*	*Total Earnings*	*Base Salary*	*Annual Increase*	*Merit Bonus*	*Total Earnings*
1993	$35,000	5.0%	$ 35,000	$35,000	3.5%	5.0%	$ 36,750
1994	$36,750	5.5%	$ 36,750	$36,225	3.5%	7.0%	$ 38,761
1995	$38,771	4.0%	$ 38,771	$37,493	3.5%	4.0%	$ 38,993
1996	$40,322	5.5%	$ 40,322	$38,805	3.5%	7.5%	$ 41,716
1997	$42,540	5.0%	$ 42,540	$40,163	3.5%	5.0%	$ 42,171
1998	$44,667	7.0%	$ 44,667	$41,569	3.5%	10.0%	$ 45,726
1999	$47,793	4.5%	$ 47,793	$43,024	3.5%	5.0%	$ 45,175
2000	$49,944	5.0%	$ 49,944	$44,530	3.5%	5.0%	$ 46,756
2001	$52,441	6.5%	$ 52,441	$46,088	3.5%	8.5%	$ 50,006
2002	$55,850		$ 55,850	$47,701		6.5%	$ 50,802
	10-year earnings		$444,079	10-year earnings			$436,855

Note: This example does not consider the time value of money or the reduced benefit costs associated with lower base salary under the two-component program.

gram, the *best* year is rewarded with a 7 percent increase. Yet, an examination of total earnings over a ten-year period highlights the dramatic cost of granting base salary increases under the traditional program. Despite its large annual bounties, the two-component program actually results in lower total cost to the company ($436,855 versus $444,079).

PROGRAM ADVANTAGES

Breaking the annual merit increase into a lump sum reward and a base salary increase offers several advantages.

1. *Reduces fixed expense.* The program could work within the guidelines of the current merit budget, while reducing the fixed expense portion of that budget. That is, if the company is budgeting 5 percent for merit increases, perhaps 3.5 percent would be allocated to base salary increases and 1.5 percent to merit bonuses (which must be re-earned each year). While the expected payout is the same, the fixed cost to the company has been reduced because the permanent base salary increase is lower.
2. *Ties total pay levels to the company's ability to pay.* Some companies currently link their base salary increase budgets to their annual performance. Although well-intentioned, companies cannot afford to commit to higher long-term fixed salary expenses because of one good year. However, the merit bonus fund, because it is a variable expense, can fluctuate with the company's performance. In a great year, the company could adopt a 10 percent merit bonus budget. In a poor year, 1 percent to 2 percent.
3. *Improves focus on employee development.* Base salary increases will primarily be used to reward job growth or employee growth that is necessary to meet business needs. Many performance appraisal forms have a developmental component, but it plays no real role in determining pay increases. In the future, this developmental component should play a major role in salary increase determination, and companies should bolster this component by developing programs that more effectively document and measure job and employee growth.
4. *Provides greater recognition for outstanding performance.* Because the merit bonus is not a fixed expense, companies can confidently allocate larger payouts for superior annual performance. Over time, without the compounding effects of full base salary increases, companies can gradually increase the merit bonus pool without increasing total costs.

ALLOCATING BASE SALARY INCREASES

In order to truly pay for performance, the reward must be reflective of the accomplishment. A base salary increase granted in January 1993 will escalate the company's fixed salary expense, not for just one year, but for as long as the employee remains with the company. Likewise, the employee will benefit from the increase resulting from that one year's performance throughout his or her career and enjoy the compounding effects of increase upon increase. Is this fair?

In some cases this is fair. Over the course of the year there may be experiences, contributions, or events that should be recognized with a base salary increase. These experiences, contributions, and events will all have one thing in common: they will raise the level of expected contribution to the company. Following are the three primary categories that would be justifiably rewarded with base salary increases.

1. *Increased job responsibility.* Over the course of the

year, the employee is assigned new or higher level job responsibilities. These responsibilities are not temporary or project-oriented, but will be a part of the employee's expected contribution for as long as he or she serves in the job.

2. *Increased competency.* Over the course of the year, the individual acquires skills or competencies that enable him or her to perform his or her job responsibilities in a more efficient or higher quality manner. These competencies must directly benefit the organization. Skills or competencies attained but not used would not warrant a base salary increase.
3. *Long-term contributions.* This category applies primarily to professional jobs, and refers to events or accomplishments that have a long-term impact on the prosperity or reputation of the organization. Examples would include accomplishments that enhance the individual's "career capital" or demonstrate potential for higher levels of contribution, such as patents, speeches, published materials or industry awards that clearly build on the firm's reputation.

THE TROUBLE WITH THE TRADITIONAL MERIT INCREASE

If current programs are not revised to reward outstanding performance in a more meaningful way (more than 10 percent of pay), employees will have little incentive to work harder and smarter.

To illustrate the difficulty of administering a traditional merit increase budget, let's look at another pay-for-performance arena— the restaurant. When we eat out, we budget a 15 percent gratuity for a waiter who meets expectations. Think back to the last time you got really bad service or really superior service. How much did you deviate from the 15 percent budgeted amount? If you are like most people, you give 15 percent about 90 percent of the time; for really special service you leave about 20 percent and for really poor service you leave about 10 percent. And, in many cases this is a gratuity for someone whom you may never see again. Is this pay for performance?

Let's change the arena to the workplace. Instead of the waiter whom you may never see again, the focus is on employees whom you manage and spend hours with each day; whom you eat lunch with; whose family and friends are acquaintances. In this situation it will obviously be much more difficult to allocate or deviate from the, for example, 5 percent merit increase budget.

By encouraging managers to distinguish one-time contributions from permanent employee advancements, the chore of allocating incremental pay will be easier. With two vehicles, the manager can better communicate and differentiate the goals of the pay program—to tie base salary to the employee's expected contribution to the firm, and to tie the employee's total annual earnings to his or her performance over the year. The more the manager is able to successfully link pay to accomplishments and events, the easier it will be to administer pay.

To return to the restaurant example, suppose the waiter were told that the gratuity would be based:

- 5 percent on taking the order within five minutes of seating
- 5 percent on bringing the check 15 minutes after serving, and
- 5 percent on keeping the water glasses filled

Because the performance required for a gratuity has been clearly articulated, it should be easier to administer the gratuity.

WHEN TO USE WHAT

To explain how to properly differentiate between accomplishments rewarded with a base salary increase and accomplishments rewarded with a merit bonus, let's consider the example of two compensation consultants: Consultant A and Consultant B.

Over the course of 1992, Consultant A writes four articles published in major periodicals; gives three speeches to large, national audiences; designs a detailed training program to develop junior practitioners; assumes new responsibility for a compensation analyst; trains and develops expertise in gainsharing plan design. At the same time, Consultant A generates only $150,000 in new business versus a target of $250,000, and bills only 750 hours versus a target of 1,250. How should incremental pay be delivered?

Consultant A obviously had some major developmental successes over the year. Because of these successes, the company will expect a higher sustainable level of contribution from the employee in the future. As a result, the company may give Consultant A a 10 percent base salary increase. But, Consultant A did very little to contribute to the company's business success in 1992. Therefore, Consultant A may earn a $0 merit bonus.

Consultant B spends every waking hour reviewing and revising job descriptions for clients, because of the tremendous interest in updating job descriptions spawned by the Americans with Disabilities Act (ADA). Over the course of the year, Consultant B generates $400,000 in new business versus a target of $250,000 and bills 2,100 hours versus a target of 1,250. Due to the time demands placed on Consultant B, he is unable to take on any additional responsibilities, or

gain expertise in any additional areas. How should incremental pay be delivered?

Consultant B's contribution to the business success of the company in 1992 was commendable. As a result, he deserves a large merit bonus, perhaps 15 percent of base salary. But, Consultant B did little to raise the expected level of his future contributions to the organization. Therefore, base salary should remain flat, or perhaps be adjusted only to maintain relative position in the salary range.

Successes must be measured in terms of 1) annual accomplishments, and 2) accomplishments or events that will have a long-term impact on the employee's ability to contribute to the organization. The scope of the reward must be congruent with the scope of the accomplishment.

A COMPROMISE FOR THE CONSERVATIVE

Many organizations use a merit increase matrix to determine the individual pay increases of employees. Using the matrix, employees' annual increases depend on their performance levels, as well as their placement in the salary range (see Table 2). The rationale is that if two employees in the same job are performing at the same level and one currently earns less than the other, the one earning less deserves a larger increase.

One may further reason that, if the salary range midpoint is reflective of the "market rate," then only those employees who exceed expectations for a sustained period should progress beyond 100 percent of the midpoint. If an employee simply "meets expectations" on a sustained basis, he or she should be compensated at the market rate, but no higher.

Companies that are determined to keep base salaries competitive with market, at all costs, may be skeptical about introducing a two-component program that threatens their competitive base salary posture. These organizations may wish to utilize traditional salary increases for those employees below the market rate of pay, and introduce the merit bonus for those that are above market.

The variable merit matrix (see Table 3) can help a company advance base salaries to the necessary competitive level, and then turn salary costs that are above market into variable expenses.

Using this matrix will move all competent employees to the midpoint over time (including those above midpoint). Hypothetically, at that time, base salaries would reflect the expected contribution for the job and all incremental contributions would be rewarded with potentially large lump sum bonuses.

Table 2: Traditional Merit Increase Matrix

	Salary as Percent of Midpoint			
	80%-90%	*90%-100%*	*100%-110%*	*110%-120%*
Performance Level	*Salary Increase*	*Salary Increase*	*Salary Increase*	*Salary Increase*
Far Exceeds Expectations	10%	8%	6%	4%
Exceeds Expectations	8%	6%	4%	0%
Meets Expectations	6%	4%	0%	0%
Meets Some Expectations	4%	0%	0%	0%
Does Not Meet Expectations	0%	0%	0%	0%

Note: Matrix indicates increase as a percent of base salary or midpoint.

Table 3: Variable Merit Matrix

	Salarly as a Percent of Midpoint			
	80%-90%	*90%-100%*	*100%-110%*	*110%-120%*
Performance Level	*Salary Increase*	*Salary Increase*	*Merit Bonus*	*Merit Bonus*
Far Exceeds Expectations	10%	8%	8%	8%
Exceeds Expectations	8%	6%	6%	6%
Meets Expectations	6%	4%	4%	4%
Meets Some Expectations	4%	0%	0%	0%
Does Not Meet Expectations	0%	0%	0%	0%

This approach provides consistent rewards for high level performers, while lowering the company's fixed cost exposure. The approach will not be as effective as the two-component approach in differentiating base salaries according to the expected individual contribution, or in the widespread application of the merit bonus that would lead to more significant reductions in fixed cost. Nevertheless, the program will bring fixed salary costs to market levels or below, and allow the company to fund any premium based on its performance.

CONCLUSION

Companies can no longer afford to permanently escalate fixed salary dollars based upon one year's performance. By breaking the annual merit increase into base salary increases and merit bonuses, companies can take greater control over fixed costs, while adopting larger merit bonus budgets that truly pay for annual performance.