Facing the Market: How Best to Align Remuneration Levels

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1. Introduction

Basic pay is determined by a review of some combination of:

- an employee's specific job role
- the need to preserve an acceptable level of internal pay equity across employees within an organisation, and
- the need to provide a competitive basic salary compared to other organisations in the marketplace, industry or region (Armstrong and Murlis, 1994).

The weighting of these factors have varied according to the type of role and the sector of employment. Over time, however, there has been a general shift away from considerations of internal equity towards external equity. The particular value of a specific job role has become less about the particular skills that the employee brought to the job and more about its market price. Zingheim and Schuster (2002) complained, for example, for 'most of the history of pay' there has been a 'nearly singular emphasis on internal equity'. The future, by contrast, they think, will have a 'foundation in competitive practice so that the company and employee have a pay relationship anchored in the marketplace.'

The impetus for this rebalancing in the private sector has been the increasingly competitive business world that has spilled over into the labour market. Winning the 'war for talent' is both symbolic of this shift and, at a practical level, a recognition that companies have to work harder to attract and keep staff. The labour market has in general tightened over recent years and some jobs are especially hard to fill, be they low level or specialist.

The public sector has mimicked the private over market pay, as it has done in a number of areas of remuneration (Reilly, 2004). The Treasury has encouraged market-driven pay through the remit process and it has been a key element in the terms of reference for the pay review bodies. The push towards local pay is the most recent manifestation of this drive. In local government, more attention has been paid to the external market, both for senior appointments and for hard to fill vacancies. The fire dispute of 2003 was also, after all, an argument about the market positioning of pay. *Agenda for Change* in the NHS explicitly acknowledges that there may be location and occupational 'hotspots' that have to dealt with by pay supplements.

In the literature, the practice under discussion in this paper is referred to as market pay, market-driven pay, market-based pay, market rating, or market pricing. Whichever terminology is used, it can be thought of as:

> *'the process of assessing rates of pay by reference to market rates — what similar organisations pay for comparable jobs.'* (Armstrong, 1999)

However, whilst there is a lot of talk about market-based pay from both reward practitioners and organisations themselves, there is a distinct lack of research about the scope of such a reward mechanism and the effects that has on both individuals and organisations. In the case of market-based pay, research lags behind practice.

This paper tries to fill some of that void.

1.1 Prevalence of market-based pay

As organisations have responded to the increasing challenges of the external environment, it has been possible to identify certain patterns of reward policies emerging with regard to the market. For example, Towers Perrin's (1999) European Reward Survey found that there was a shift from internally focused to more market-based pay, in that the majority of respondents placed external market alignment in their top three reward objectives. The reasons given for this were that market alignment was thought to aid recruitment and retention.

Brown (2002) also contends that organisations are now much less concerned with internal equity, and that over the last decade, concerns about the fairness of internal relativities has slipped way down organisations' hierarchies of objectives. The Towers Perrin research further reported that 73 per cent of the organisations surveyed make 'separate arrangements' for specific job roles in which the market demand is high. The separate arrangements referred to are typically market supplements which are increasingly a common feature in both public and private sectors (IDS, 2004). Other research by IDS (2003) that has concentrated on the finance and banking sector, for example, confirms that the factor that currently has the largest influence on pay determination is an employee's position in the pay band relative to the market rate. Moreover, in the utilities sector, the use of market-based pay is common in determining pay levels. (IDS, 2003).

2. Establishing the Value of a Job

There are several perspectives from which the value of any given job role can be determined. Here, we consider three ways: it can be based on intrinsic value, internal relativities and external relativities.

2.1 Intrinsic value

In an absolute sense, the intrinsic value of a job is concerned with the specific job role and the required attributes of the employee:

> *'The concept of intrinsic value is based on the apparently reasonable belief that the rate for a job should be determined by reference to the amount of responsibility involved or the degree of skill or level of competence required to perform it.'* (Armstrong and Murlis, 1994)

In line with this, levels of pay will be influenced by factors to do with the job itself, such as the breadth of responsibility given, the amount of resources controlled, the level of authority, the degree of autonomy they have to make decisions *etc.* Perceptions about the intrinsic value of a job are influenced by both individual and organisational outputs. That is, influence will come from the output of the individual employee themselves, and also the extent to which they are able to influence the output of the organisation as a whole. However, the difficulty with a concept such as intrinsic value is that it ignores other factors that may affect the value of any given job role. The trouble is that the value of one job will always be relative to another job. So, in reality, the value of a job is always influenced by other factors.

2.2 Internal relativities

From this perspective, taking an organisation as a whole, the value of a specific job is determined by the perceptions of the importance of that job role compared to other job roles. Internal relativities mirror these perceptions of importance so that the more important a job is perceived to be, the more pay that job will receive. Perceptions of internal relativities can be based on a range of information regarding both the required inputs and outputs of a given job role. For example, in terms of inputs, this information may relate to skills and competencies. In terms of outputs, the information may concern the competitive edge a certain employee can give to an organisation.

Thus you tend to see particular occupations having higher value in some companies than others. For example, aircraft pilots are vital to the RAF and airline companies in a way that is not the case in most other organisations. Pay systems are then oriented around this key and/or predominant skill group. The Crown Estate, therefore, centres its pay levels around surveyors who comprise the most numerous occupation and the most important. Other occupations are then fitted in around the core group.

The inputs/outputs noted above are typically built into a job evaluation system that sets the internal relativities. In a factor-based scheme, the factors selected aim to recognise either skills/competency inputs or key job characteristics, like degree of responsibility for resources or the complexity of decision making required.

2.3 External relativities

In the most elementary terms, a basic salary is simply a price that represents the value of a service to the buyer and the vendor; in other words, the organisation and the employee respectively. Therefore, the laws of supply and demand might be expected to determine the external market rate for any given job. This simple economic proposition implies an analogy with other aspects of the business proposition. As an American remuneration consultant put it: 'Just as organisations compete to sell their products and services, they also compete with one another for talented employees within recruiting markets.' (Fusco, 2003)

External relativities are usually assessed by reference to what similar organisations pay for comparable jobs. This can be done in a structured way via salary surveys, or in an *ad hoc* manner by seeing what competitor organisations are offering in job advertisements. Potential or actual recruits can be quizzed on the pay they have been offered elsewhere. Some organisations would test all their jobs in this way, others merely a sample.

If they do test all their jobs against the market on a frequent basis, then this substitutes for job evaluation. The market fully sets internal relativities. If a sample is used based on key jobs (see above) and/or a representative cross-section of jobs, then there is more of a combination of internal and external alignment. This is because in practice a salary survey is often a grade-based review of the market. Job evaluation sets the internal relativities that place roles in grades. The market then in a generalised sense puts the grade in alignment with the market.

Alternatively, market pricing can determine internal benchmarking. In this situation, the grade structure is produced by establishing the market rates for a range of benchmark jobs. Any job roles not included as benchmark jobs are then slotted into the newly formulated grade structure.

Sources of information on market pay are covered in more detail later in this paper.

2.4 Internal versus external environments

In developing a reward philosophy, therefore, senior management must determine the extent to which pay within the organisation should be driven by external market forces. In other words, a reward policy needs to be established by gauging the extent to which rewards should be market driven as opposed to being internally equitable. The assessment of both internal and external environments will provide the data needed to develop effective reward policies. If an organisation has difficulty in either recruiting or retaining particular individuals who are currently in demand within the market place, the organisation may have to relinquish its philosophy of internal equity and pay the going market rate:

> *'The pay management process must cope as best it can when the irresistible force of the market place meets the immovable object of internal equity.'* (Armstrong and Murlis, 1994)

When situations like this arise, there will be a degree of conflict between market rates and internal equity. Indeed, conflict such as this is hard to resolve and there may no one solution that will provide the answer. This is why many organisations have not pushed to either extreme: they have tried a middle position of responding to the market, whilst being sensitive to internal considerations.

Internal equity may also be more complicated than simply being the opposite of external. Internal equity may relate to staff wanting to be paid the same as immediate colleagues, within the same location for the same type of job, or it might be for parity with those in different business units doing analogous work. In other words, the reference point may vary with circumstances. This is important because of both equal pay considerations and matters of retention and motivation. As the government has found, civil servants may claim equity across Departments not just within them, and, as manufacturing firms have found, employees at one site may look to be paid on a par with those at another.

What our introduction indicates, however, is that increasingly organisations have tended to emphasise the need to respond to the market, even if this is at the cost of internal equity. This repositioning might be philosophical (organisations should be market driven) or pragmatic (if we cannot recruit and retain we are dead). It may also acknowledge that the trade unions, which have been the principal proponents of internal equity, have been weakened over the last 20 years.

3. The Issues of Occupation, Sector and Location

If an organisation is considering market-driven pay, what are the principal components of the market it should consider? The three that we will give attention to are those that seem to be the most important and common determinants for organisations. They are:

- occupation
- sector
- location
- grade.

3.1 Occupation and market-based pay

In organisations where there are strong functional groups then market-driven pay may be oriented around occupations or professions. Thus the NHS traditionally has had different pay systems for doctors, nurses, physiotherapists, *etc*. Without going so far as this, other organisations have identified key groups and treated them, to varying degrees, in a different manner from the rest. Their pay scale might be higher (not usually lower!) than comparable groups. Finally, organisations may use market allowances to supplement base pay, especially where there are recruitment and retention difficulties.

Particular interest in recent years has focused on the idea of 'job families' as a means of handling differences between occupational groups. (For further information on this topic please refer to the paper on the IES members' section of the website.) In its most basic form, job families are groupings of jobs with similar characteristics. These characteristics usually focus on common competencies, skills and knowledge, but they may relate to having a similar purpose or process. So job families often represent distinct occupational or functional groups.

Over one- fifth of organisations now operate job-family-based pay structures (D Brown, 2001). They have different, market-based pay ranges and sometimes totally separate pay structures for jobs of a similar size, but in different functions or occupational groupings. The concept allows organisations to treat occupational or functional groups differently from each other in terms of reward, career paths or development needs. These occupational or functional groups may or may not be linked to business unit structures. If they are, job families act as a means of vertical integration for an organisation. (For example, some organisations have a separate job family for call centres.) If they do not, job families provide horizontal integration. Support or corporate functions, like HR, Finance, IT, *etc.* may be distributed across the organisation in devolved management structures. A job family approach brings together these disparate groups. Thus this type of job family is sometimes described as 'generic' — covering similar types of work across functional boundaries. Other job families may be found only in the one business unit, division or department — such as sales and marketing or production.

Clearly the ability to differentiate the pay of one occupational group from another is central to the benefits of the job family approach. Different occupational groups have different values in the market place and these can be reflected in internal pay rates.

Getting pay aligned with the market should assist recruitment and retention. In conventional pay systems, recruitment to the minimum of a pay range offers simplicity, transparency and protection against equal pay claims, but this method lacks the flexibility to deal with different types of applicant. These differences may well be occupationally based. Thus it may be hard to recruit a marketing person on the same salary as a production specialist. Job families allow the organisation to set entry pay at different levels to reflect these occupational market differences.

Retention should equally be improved because, through job families, the organisation is paying market rates. This reduces the chance that an employee will leave for extra money. It does not eliminate the risk. Rivals, determined to get their man or woman, may exceed normal market rates if they think that necessary. And, of course, money is only one reason (and not always the most important reason) for resignations.

There are also practical reasons for adopting job families when trying to use market rates. As Hertfordshire County Council (*Personnel Today*, 2002) found, trying to benchmark 1,500 jobs against the market is an impossible task. Collecting information on market rates for a much smaller number of key roles within each job family is much easier to contemplate.

The Nationwide Building Society found that introducing market related job families substantially cut the number of *ad hoc* payments that had grown up over the years to deal with various remuneration problems. Removing these payments helped fund the introduction of the job family system (IDS, 2002).

3.2 Sector and market-based pay

An alternative approach for organisations seeking to be competitive is not to see that their pay compares favourably with other employers using the same occupational groups, but to make sure that their remuneration is in line with other organisations in their same sector.

Sector seems to be important both for public and private sector employers. Research by Arrowsmith and Sisson (1999) found that the most influential factor in determining pay levels is what other organisations in the relevant sector are doing. They discovered that when one organisation adopts change, other organisations within the sector follow. They described this as the 'convoy principle':

> *'a strong sector effect is demonstrated … employers tend to move like ships in a convoy when managing change.'* (Arrowsmith and Sisson, 1999)

One reason why this happens is the use of sector-based salary benchmarking clubs. Take the public sector: there are pay surveys conducted for local authorities, and the Cabinet Office offers a pay database to government departments and agencies to enable them to compare their pay levels. Similar clubs exist in the private sector, *eg* in financial services. There are three particular reasons why these clubs work:

- A practical one — jobs are easy to compare because they are often so alike.
- There is often, therefore, a broadly common occupational profile.
- Internal valuation may be similar — *ie* if job evaluation is used, the grades are distributed in a similar way.

So on the one hand, benchmarking can be easy to do and the emerging results reliable. On the other hand, these organisations are in competition with one another for the same skills. It is for the latter recruitment and retention reason that organisations are loath to be seen to be behind their competitors. There is a certain safety in being part of the convoy. This is particularly true for those occupations that are found only within that sector. This may be because market issues concern the specific sector, not the wider labour market.

But keeping to the wartime shipping analogy, convoys are vulnerable to attack by external forces. You see this when new predators enter the market and target the weaker part of the convoy. The public sector has periodically suffered from attacks from companies seeking particular skills to be found, for example, in the civil service, be they tax accountants or economists. Substantial salary uplifts may be on offer that tempt staff away, despite satisfaction found in the intrinsic nature of the job (Audit Commission, 2002).

Another difficulty may arise for those organisations operating in a number of sectors. A sector-driven approach would suggest that consistency with a variety of external markets might be more appropriate than achieving internal harmony. However, as we remarked on page 5, the employees might take the opposite view.

3.3 Location and market-based pay

The issue of local pay in the public sector has recently received much attention from the government. In the 2003 budget, Gordon Brown raised the question of pay flexibility as a means of more cost effective departmental spending. He suggested that localised pay arrangements might have more merit than national schemes because they could be better aligned to market circumstances. The Treasury argued that the private sector is more efficient in responding to labour market signals, and if the public sector can be just as flexible it could see benefits in service delivery (through a better response to recruitment and retention hotspots) and value for money.

For the private sector, increasing market alignment might mean relating to geographical differences as much as to occupational or sectoral.

Local pay avoids having to work on the basis of a national pay system that may only imperfectly match the various labour markets within which the organisation operates. National pay systems of necessity have to average out pay rates across the country, irrespective of the recruitment or retention ease or difficulties of particular locations. This may mean that some staff are relatively overpaid for their locality, whereas others are underpaid. With local pay, resources can be steered towards the locations in which more pay is required. Not only will this aid recruitment and retention in areas in which difficulties are emerging, it also reduces the 'dead-weight' effect of increasing pay levels on a national basis when increases are only required in specific locations to match the current market rates.

Moreover, quality of staff may suffer if pay rates are too low. Vacancies may remain unfilled. Agency staff may have to be used at greater cost, and questionable quality. *Ad hoc* solutions may be found that corrupt the grading system or generate other internal inequalities. Conversely, if there is overpayment, the labour hired may be over qualified for the work and the payroll cost higher than it need be.

There are different ways in which local pay can be applied. It can be implemented on the basis of:

- separate local pay scales
- pay supplements, or
- devolving the responsibility for pay determination to line management.

Having base pay differences according to location makes sense if organisations believe that these differences are long term and structural, rather than short term and temporary. This is demonstrated by the fact that it will affect pensionable earnings, meaning that staff working in high cost/tight labour markets will benefit into their retirement.

But incorporating an allowance into base pay, or using base pay variability from the outset, is a dangerous policy if the labour market is at all volatile. It is harder to readjust base pay than remove a temporary allowance (though this is difficult enough). Pay differences need to be kept under regular review, otherwise pay leads may persist for much longer than is justified. This clearly is costly, but it also raises equal pay difficulties.

An alternative approach to dealing with the problem of having to operate in numerous and varied labour markets, is to set the national rate below the highest paying areas and use allowances to top up. London (and increasingly South Eastern) allowances are the most obvious example of this approach. Using supplementary allowances is an adequate response so long as they can be given and, just as importantly, removed or adjusted quickly as conditions change. Organisations usually find it easier to give allowances than take them away. As with base pay, allowances often get stuck, neither rising nor falling sufficiently as circumstances change. Again leaving allowances unjustifiably adds cost and risks claims of discrimination. Conversely, though less commonly, allowances are not extended to locations where the labour market has become tighter and the requirement for additional money is clear-cut.

Where there is devolvement of pay decisions, line managers have the flexibility to change individual salaries or offer different starting pay in response to local circumstances. Frequently, this is combined with other factors, *eg* especially performance, in adjusting individual pay levels (IRS 2001). This gives more flexibility than the other two approaches. It can be more responsive to labour market signals. It can be more specific than pay set on a pre-determined regional basis. The risk is that managerial discretion is not properly exercised. Managers may be overly generous in boosting pay rates or they may do it in a discriminatory manner.

Whatever the approach, location-based pay frequently suffers from a lack of clarity in the reasoning behind its introduction and consistency in the way that it is subsequently delivered. Is it offered to deal with recruitment or retention failings? Is it set simply because a local pay survey calculates a shortfall against the market? Or, is it determined on the basis of a cost comparison: how living costs vary between locations?

Pearson *et al.* (2004) note further difficulties in relating pay levels to local areas. Decisions need to be made on how the definition of the locality should be determined and how boundary problems can be avoided. The issue of job mobility also needs to be considered. Job mobility has been a consistent feature of much public and private sector career management and has supported the professional integrity of the system (Brown and Walsh, 1991). Whilst national pay systems allow employees to be transferred between different locations, local pay may well give rise to employees drifting to localities in which they will receive the highest pay. Furthermore, especially in unionised environments, there is the danger of wage inflation. This is because there is a risk that one location will leapfrog another, producing a constant game of catch up. Nickell (1997) argues that the evidence shows that leapfrogging (and consequent wage inflation) is a feature of 'decentralised, uncoordinated, union dominated systems'.

Then there are the problems associated with collecting and maintaining up-to-date information about market rates, though these are difficulties associated with all forms of market pay. The particular issue with respect to pay determined by location, is that organisations need to decide on what basis to divide up their workforce into pay areas. The options include:

- Travel to Work Areas (TTWAs)
- business units
- natural geography
- government boundaries.

TTWAs can precisely reflect the labour market within which the organisation operates, which involves a lot of detailed data collection. Using business units means that you reduce the internal boundary disputes, but may not reflect the labour market from which you draw staff. Geography may well affect the TTWAs, if for example transport links reflect the natural environment, but this may be coming less and less true. Government boundaries are probably rather artificial constructs in this setting. They may however have more relevance for the public sector.

Whilst it is hard to dispute that there should be a link between location and pay, in reality, as we have seen, such a relationship is difficult to achieve. Evidence from both geographical pay dispersion statistics and research on organisational behaviour, substantiates this assertion. Outside the South East, there is, in fact, only limited wage differentiation between regions (NERA, 2002). And many large organisations, particularly those in the finance and retail sectors, have common, national pay systems (IDS, 2003). Besides offering higher pay in London and possibly the South East (through higher base pay or allowances), some large, private sector employers do have pay 'zones' that offer the possibility of some divergence from the national norm. However, these are strictly controlled from the centre.

(For further information on this topic please refer to the paper on the IES members' section of the website.)

3.4 Grade

Matching the market on the basis of pay grades or points is self evidently obvious. If the organisation is trying to match the market it has to do this on the basis of comparing job hierarchies, otherwise like is not compared with like. We only refer to grade specifically to highlight that:

- grade groups may have very different labour markets from each other. This is particularly true of senior executives and graduates. This may be a matter of:
  - geography - labour markets are likely to widen with grade from local to international, as illustrated in Figure 1
  - sector – the search for graduates or top players may be cross sectoral in a way that contrasts with positioning the rest of the organisation
- different selection criteria may apply based on grade – *eg* more of a case of paying for potential than track record at the key entry points for new recruits
- there may be key break points between groups in the grading system where significant changes apply to your terms and conditions (*eg* shopfloor, 'staff' and executive). A recent trend has been for organisations to reduce such variation in a drive to harmonise the employment deal.

Figure 1: Different markets for different groups

	International	UK	Internal	Regional	Local
Main board	✓				
Senior managers	✓	✓			
Managers		✓	✓		
Staff		✓	✓	✓	✓
Works				✓	✓

Source: A manufacturing company

4. What Drives Interest in Market-based Pay?

For many organisations, interest in market-based pay is driven by a desire to enhance organisational flexibility and efficiency by increasing recruitment and retention, controlling costs, and increasing employee motivation.

4.1 Recruitment and retention

At its most elementary level, the main rationale behind implementing market-based pay is that the more competitive an organisation is in the market place with regard to reward, the better quality of employee it will attract. Similarly, by paying above the market rate, the less likely it is that quality employees will leave the organisation to take up better-paid jobs elsewhere.

In relation to this, research by IDS (2003) states that widespread recruitment difficulties in local government has led to increased differentiation in pay levels in different localities:

> *'Pay looms large as a reason for local authorities' staffing difficulties.'*
> (IDS 2004)

Similarly, according to other research conducted by IDS (2004), organisations have principally centred on pay levels to remedy recruitment and retention difficulties. In a large-scale survey of both private and public sector organisations, approximately 50 per cent of respondents had implemented, or were looking to implement, pay supplements. More than half of respondents reported giving pay supplements for jobs in which there were recruitment or retention difficulties. This is no doubt a reflection of the tightening of labour markets in recent years and fierce competition in some areas of the country and for particular skills.

In terms of their effectiveness, many organisations thought that market supplements had been extremely effective in easing recruitment and retention difficulties. This is despite evidence that employees do not leave organisations because of remuneration, especially in the public sector (Audit Commission, 2000).

4.2 Cost control

As mentioned previously, one of the most obvious advantages of market-based pay is that money can be directed towards the locations or occupations in which more pay is required, thereby reducing the 'dead-weight' effect of increasing pay levels on a national basis, when increases are only required in specific locations/occupations to match the current market rates.

However, organisations need to be careful that their favoured means of cost control does not backfire. Some organisations have found that the job family approach can be inflationary if line managers operate it by overrating the market value of their staff. We indicated above that there is a risk of leapfrogging in locational pay and one can see similar wage drift if internal competition develops between occupational groups or business units.

4.3 Organisational flexibility

Mergers and acquisitions may push organisations to market based pay. If two companies are joined that have been internally focused in their pay arrangements, one way to consider harmonisation is to look to the external market. This would allow both parties to the merger to find a justifiable reference point that does not favour one group over another.

4.4 Employee motivation

It is all too easy to lose sight of the impact of market-based pay on individual employees. These is some research evidence on the importance of fairness in employees' perceptions on how they are rewarded compared to people doing similar jobs in different organisations. 'Pay referents' are those people with whom employees make pay comparisons.

Employee satisfaction with pay levels is important because it has been found to have an effect on levels of absenteeism and turnover (Cotton and Tuttle, 1986). Several empirical studies have demonstrated that pay equity is a strong predictor of pay satisfaction (*eg* Weiner, 1980). There is some dispute about whether internal or external equity has the stronger impact. The answer probably depends on the occupational group under review. However, the research reported here demonstrates the principal role external equity plays.

A study of US academics found internal equity a little lower than external in its importance to overall satisfaction with pay (Terpstra and Honoree, 2003). Goodman (1974) also found that pay comparisons involving external referents were more strongly associated with employees' pay satisfaction than comparisons involving a number of internal referents. If we consider that decreased pay satisfaction is associated with increased absenteeism and turnover, then it follows that an employee who perceives that they are getting a 'bad deal' compared to someone performing a similar role in a different organisation is unlikely to add value to an organisation. Indeed, Blau (1994) further found that pay level satisfaction is affected by perceived discrepancies between the employee's pay and the pay of external referents.

In a recent empirical study by Brown (2001), the impact of five different pay referents on pay satisfaction were assessed. The five pay referents assessed were:

- market
- organisational
- financial
- social
- historical.

The study demonstrated that the market referent was the most important comparator to all employees and that this referent had the greatest impact on pay level satisfaction. This finding has serious implications for organisations' reward policies. It is clear that pay equity is important to employees and that this has implications for pay level satisfaction. Moreover, as market referents have the greatest impact on pay level satisfaction, at least organisations are able to act in response. For example, market pay surveys will allow access to information about rates of pay in the market that can be then used in pay determination.

It is important to mention here that some reward practitioners (eg Demby, cited in Personnel Today, 2000) argue that the wider availability of information on earnings will lead to an escalation of pay demands. Demby contended that the growing amount of pay data available over the Internet is making it easier for employees to find out what the industry norm is for their job, such that:

> *'Mainstream professionals will soon be comparing their pay rates in the same way as footballers and company directors.'* (Personnel Today, 2000)

Equal pay questionnaires have the potential to add to this effect.

Taking this into consideration, it makes it even more important that individual rates and relativities should be adjusted in the light of changing market pressures, if the organisation is to recruit and retain quality employees. This is particularly salient with regard to employees whose market worth is high and who are therefore susceptible to the attractions of better-paid jobs elsewhere. Organisations ignore at their peril the individual market worth of any employees they wish to retain whose talent is at a premium in the marketplace.

5. Market-based Pay in Practice

5.1 Techniques

In order to monitor market rates, organisations can use pay surveys and various benchmarking methods to monitor their competitors, and then incorporate market adjustments into pay reviews. In Towers Perrin's European reward survey (1999) 97 per cent of organisations regarded external market pay surveys as being an essential component of their reward strategy. Indeed, aided by the growth in online databases, the number of pay surveys being conducted in the UK has increased dramatically.

In addition, it would appear that job evaluation systems are now being implemented with increased flexibility. Moreover, job evaluation is becoming increasingly business-aligned and market-driven in two ways. Firstly, by using fewer pay bands with market-aligned ranges; and secondly, by shifting to simpler job classification approaches, such as job families. Armstrong (1999) notes that many organisations are using both of these approaches, and that hybrid designs are emerging as organisations pursue an element of both internal and external fit. For example, as Armstrong notes:

> *'The same job family definitions in some sectors are being used both as the basis for internal pay structures and external pay benchmarking. In other organisations, the points weighting for particular internal evaluation factors now relate to their correlation with market data, while some use market value as a factor in itself. So, defining a policy on market definition and stance, monitoring and maintaining that position, and reflecting labour market variations are all important components of an effective reward strategy.'* (Armstrong, 1999).

5.2 Issues to consider

5.2.1 Accuracy of market-rate data

Incorporating an element of market-based pay into an organisation's reward strategy can be both effective and straightforward. However, in practice, not only is it difficult to analyse job roles thoroughly, it is also difficult to conduct comprehensive market pay surveys. The main problem with a market-based pay approach is that it is reliant on how accurate market rate information is.

Demby, (in *Personnel Today*, 2000) argues that the increasing quantity of market data has been accompanied by a decrease in quality of the information. Indeed, she asserts that concerns such as these may explain the fact that most internal HR practitioners do not share market data with line managers or employees. It is important to note that this remains the case despite the fact that their pay decisions may ultimately be based on it. In addition, such a policy goes against what many organisations are trying to achieve in terms of developing a transparent reward strategy that is understood and supported by employees. The issue of transparency will be further discussed later in this section.

One of the main problems regarding the accuracy of market rate information is that there is no single market rate of pay for a given job. The market only allows the assumption that people occupying equal positions tend to be paid equally:

> *'The process is circular … we know what people are worth because that's what they cost in the job market, but we also know that what people cost in the job market is just what they're worth.'* (Kanter, 1989).

There is a whole range of pay rates visible in the market, and organisations need to determine where to position its employees within that range. This is dependent on a number of factors, such as how it wants to be perceived in the market place, the degree of choice it wants in recruitment applicants, and whether or not it can afford to adopt the position it wants. As Gomez-Mejia and Balkin (1992) contend:

> *'While the myth persists that the market wage can be accurately and scientifically determined as a single rate, in fact there is a wide range of market pay rates available for each occupation, and the determination of the going rate for a job is a combination of art and science. Thus, the combination of decisions that determine the market wage for a firm leaves room for a great deal of subjectivity due to the many judgements that must enter into these decisions.'*

Taking this into account, it can be seen that no market pay survey can ever state the 'correct' rate of pay for a job, because in reality, it does not exist. In practice, external labour markets always offer a range of different pay rates for a given job because:

- organisations' policies differ in the amount they need to pay
- people have their own individual market rate. This will depend on their experience, competence, lifestyle choice and the extent to which they are in demand.
- individual market worth is variable, and judgements concerning value can, and often are, more to do with perception than truth
- the bigger an organisation is, the more it is likely to pay

- rates of pay are higher in some local labour markets than in others.

Other issues to consider concern the fact that the accuracy of market-rate data is, in part, dependent on the extent to which similar jobs are compared with each other. Comparing jobs that have the same title does not always provide an accurate measure, because a job in one organisation is likely to have different responsibilities to the same job in a different organisation. In practice, it is very difficult to achieve an accurate and meaningful comparison.

Lastly, with regard to the issue of timing, the data published in market-rate surveys can often be behind the times. Pay levels can change very quickly and some employees may have moved in or out since the survey was conducted.

5.2.2 Availability of market-rate data

With reference to the availability of market data, the information may be difficult to obtain in the first place. For example, Armstrong (1999) argues that the assumption that it is always easy to get hold of comprehensive and accurate information on market rates, is ill-founded. He suggests that this is especially true for organisations that find themselves in unique or specialist domains. In organisations such as these, it is more common for organisations to develop and grow their own people internally. When this situation arises, there is no standard available from which to assess the jobs based on detailed analysis of defined criteria.

Pearson *et al.* (2004) posed the following questions in considering comparative data:

- Are there external jobs that can be used to match those in the organisation, especially where they are unique?
- How easy is it for an organisation to define its market, given that this might be different for different occupational groups?
- What market position is the organisation aiming at?
- Is it practicable to compare all the terms and conditions between organisations?

  (The concept of total reward would go beyond the terms and conditions of employment and look at issues such as job satisfaction and job security. How do you assess these and then price them?)

Though this list was compiled specifically with respect to the public sector, it applies equally to other types of organisations. Questions such as these illustrate the complex issues involved in identifying appropriate comparators.

5.2.3 Pay equality

A worrying problem with market-driven pay is that attention to market rates can be discriminatory against women, in terms of equal pay. The reason for this is that if market rates for job roles that are typically occupied by women are undervalued due to an historical gender bias, then this will be mirrored in the pay structure. Consequently, this can cause conflict between the principle of internal equity and the perceived need to be competitive. Most of the time, organisations create pay structures that strike a balance between the competing imperatives of internal equity and external competitiveness. However, these compromises may still remain discriminatory towards women.

Another common difficulty relates to managing pay relativities between job families that may in turn lead to equal pay problems. These can be of two sorts: market matching and job evaluation. Difficulties with market matching can arise if either the organisation does not do a good job of finding appropriate comparators and comparing pay rates, or because there are genuinely few comparators in the external market (a particular problem in much of the public sector). Poor market comparisons for either reason can lead to the setting of differentiated internal pay rates, by occupation, that fail any equal pay test. In other words, differences between groups cannot be objectively justified.

Linked to this point is that it is not easy for some organisations to vary pay levels with fluctuations in the market, especially if different job families have different base pay levels. Even pay supplements introduced on a temporary basis may become institutionalised. Staff object to seeing them withdrawn; line managers are reluctant to push the point. The consequence is that the organisation is left with differential pay levels it cannot justify, leaving itself open to an equal pay claim.

With respect to job evaluation, the job family approach may fail because it is assumed that matching jobs to the specified grade criteria is a sufficient defence against equal pay for equal value work. It is unlikely that the defence would work. The proper defence is to have and use an analytical job evaluation system that compares elements of jobs against (usually) a set of common factors. The sort of 'whole job' comparison offered by job family methods is a poor substitute.

5.2.4 Risk of retention difficulties for key players

An additional quandary for organisations adopting a market-based pay approach is that because they tie key players to their organisation through the pay packet, they are more likely to leave if another organisation offers them more money. Indeed, when this situation arises, the logic of a totally market-based pay approach for free agents implodes. Brown (2001) contends that this has happened with footballers in the Premier League, he ponders:

> *'The weekly wages of Premier League footballers in England … may be taken as a demonstration of either the complete triumph, or the ultimate failure, of a totally market-driven approach to rewards. How can you ever establish a true market rate for a position, with such massive variations depending on the individual player concerned?'* (Brown, 2001)

5.2.5 Devolving responsibility for pay determination to line management

According to research, organisations are now more likely to involve line managers in reward issues as opposed to the HR function controlling reward issues (Towers Perrin, 1999). In addition, as there are now more systems for linking pay to performance, this has also involved the devolvement of responsibility for pay determination from the HR function to line managers. Brown and Armstrong (1999) argue that the devolution process appears to have accelerated:

> *'It has been hailed as something of a universal process solution to the problems and paradoxes of performance related pay, they key to implementing HR and reward strategies in practice.'* (Brown and Armstrong, 1999)

Many practitioners, for example, Hutchinson (1998) have supported this view, advocating wholesale devolution and empowerment of line managers, with the stated benefits of improved business and organisational fit; better relationships between local business needs, performance and pay; and much greater local support and ownership. Research generally supports this rationale and agenda for devolution. Indeed, Jackson (1993) in a study spanning five sectors, found that that business and organisational drivers were primarily with regard to devolving the responsibility for pay determination to line management. The need to tailor systems to local needs and strengthen pay for performance linkages was found to be of secondary importance.

Questions have, however, been raised about the efficacy of devolved responsibility for reward. Lack of line management accountability and ownership was raised as a concern by 30 per cent of organisations in Towers Perrin's European reward survey (1999). Doubt about the competence and willingness of line management to actually manage pay and reward schemes regularly emerges from research and experience in organisations that have devolved these decisions. Numerous examples are given of situations where line managers have ended up costing organisations a small fortune by operating reward policies in an inflationary manner. Brown and Armstrong (1999) note:

> *'Despite the strong arguments for devolution, we often find that organisations are often reluctant to put it into practice, or at best make only a half-hearted attempt to do so. Perhaps this is because some HR*

> *specialists seem to believe that line managers are generally not to be trusted to do what is expected of them so far as their responsibilities for people are concerned.'*

This remains a contentious point. Hutchinson (1998) found little evidence of major difficulties in handing over responsibilities to line management. Others would argue that they have had the same experience. The fact that there evidence is produced both ways suggests that the answer of the question of managerial competence probably depends on the skills of the managers and the cultural environment within which they operate.

5.2.6 Transparency

As mentioned previously, one of the benefits of the job families concept is that it can offer greater transparency, especially with respect to career paths. Employees can see how they will progress in career terms and that must mean grade/band terms. This might reasonably encourage more disclosure of pay progression. In companies where the publication of pay information has not been acceptable, this poses a challenge. It may be beneficial to the family members to see how their pay grows with added responsibility/challenge in their work; the difficulty may be the read across to other families. Some organisations want staff to concentrate on their own individual pay: how does it compare against the market for them? Full disclosure of pay levels inevitably means that people will look over their shoulders to what their colleagues in other families get. Greater transparency may have benefits in terms of an equal pay defence, if that is required. It means that the organisation may have to publicly defend its pay relativities. This may be uncomfortable, but it does reinforce the need for getting good quality data in the first place.

6. Conclusion

Market-driven pay is here to stay. It cannot be otherwise. Organisations compete for employees in the labour market: they therefore will expect to take note of what competitors offer. However, though some commentators, especially from the USA, would want to banish thoughts of internal equity, it is not so simple. In large, complex organisations staff will want to be assured that colleagues contributing the same effort in jobs with similar responsibilities will get roughly the same money. Job evaluation offers to provide a rationale to the internal pecking order. If the scheme is well chosen, the factors used will reflect what is important to the success of that employer. Moreover, factor-based job evaluation schemes offer some protection against equal pay claims. This is why, despite the frequent obituaries, job evaluation appears to be alive and well (Amstrong and Thompson, 2003).

What one can therefore expect to see is organisations continuing to balance internal and external relativities. In determining the latter, we have described how central is the role of the sector. For good competitive and practical reasons, organisations will look at how other similar employers pay. However, organisations would be wise to look further. For lower-level staff, sector is likely to be far less important than location. These people cannot afford to travel far and so will look in their local town for employment. This may well cut across sectoral boundaries. Employees may be prepared to switch from a shop to an office to a factory. By comparison, other professional groups will only move within their occupation and, at higher income levels, they may become very mobile.

The conclusion one can draw, is, as ever, that setting your remuneration policy is a matter of horses for courses. Different approaches may be needed for different groups. This applies to both the relative importance given to external and internal equity, and to the different types of external referent. What is required is judgement. This is particularly true when looking at external market data. This is a matter, as Gomez-Mejia and Balkin (1992) said, of a combination of art and science, though some might regard this as more of a black art! Managers should not believe that when the markets speaks, all they have to do is listen. They must use more of their critical faculties to get the right sort of answer. Which is why devolving pay decisions to line managers can be problematic. It is necessary to give managers all the data they need, but they have to be skilled to use the information.

This suggests that HR still has a vital role to play in contributing to the development of remuneration policy, the acquisition of robust (or at least as robust as possible) pay data from various sources, and support to managers who are exercising judgement in the use of that data. The HR function, too, can help the organisation recognise that the impact of the external environment on its reward options. This includes the impact of government regulation. For example, the national minimum wage has clearly affected pay levels at the bottom end of the market. And organisations need to acknowledge that the labour market is not static. This is not just in the sense that unemployment rises and falls, that earnings growth ebbs and flows, but also because what employees want from work will alter. A case can be made that organisations can expect higher wastage, as loyalty to the employer becomes more conditional and employee demands grow. Staff may only stay if they get what they want, and this may include a broader deal – not just money and a career, but also benefits and work satisfaction. This suggests that employers will need to take a more holistic view of what attracts and locks staff in. It may be that market alignment means more than money, and that organisations may have to emphasise their values as much as their cash.

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