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Total Pay Matters

by John Hankerson

Factors beyond our control have conspired to make pay management hard. Skyrocketing healthcare costs, underfunded pensions, economic woes, and cost-control pressures are just a few of those factors. All too often though, our response is to manage one pay element at a time, failing to recognize that the whole can be greater or smaller than the sum of its parts. Benefits managers work on medical plan changes, compensation managers adjust base salaries, and pension committees direct their attention to investment and valuation issues that directly affect the retirement plan, often with little involvement or coordination with one another.

The solution to the challenge of pay management today is to think and act strategically about total pay. This means seeing each element of total pay as part of your organization's toolbox to attract, retain, motivate, and focus employees.

A Strategic Response

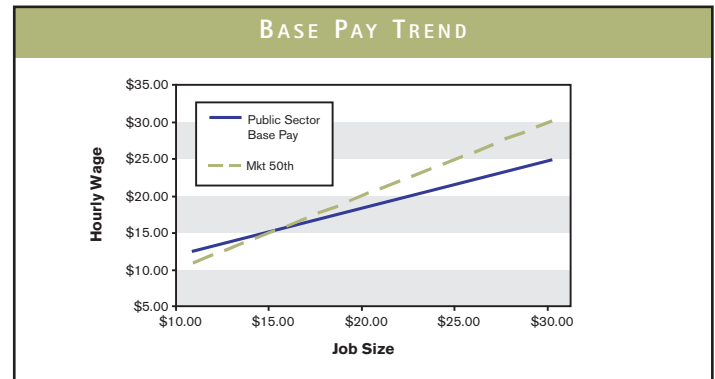
The first step in building a strategic response is to focus on the "majors" in total pay. This means a focus on cash compensation (base pay plus incentives), medical benefits, and retirement benefits. Changes to life insurance, disability, vision, and dental benefits do little to increase the actual dollar value of the total pay package for most employees. For example, at a \$40,000 salary level, these "minor" benefits typically represent less than 5% of base pay in employer-paid value to the employee and individually do not buy an organization much in the way of competitive advantage in recruitment or retention.

Public sector organizations have behaved in predictable ways when it comes to cash compensation. Generally, public employers have provided better than average cash compensation to lower level positions and significantly below average compensation to professional and managerial positions. Figure 1 depicts these findings.

In contrast with base pay, our review of some large public sector employers resulted in some "surprises" when we compared benefits.

Public employers tend to provide more generous benefits for medical coverage, defined benefit pensions—though often requiring member contributions—and retiree medical needs. It should also be noted that in some cases, public employees do not participate in Social Security. (See Table 1 on page 2.) These rich benefits combine to significantly increase the cost of total compensation. But do they provide a "return" on the investment made? The public employers in our studies had higher total pay costs for the majority of their employees but no evidence that these higher costs produced higher performance or results. The question we must ask is whether the current mix of cash and benefits meets the short- and long-term needs of public organizations as they strive to attract and retain a qualified workforce.

FIGURE 1



Keeping in mind the need to focus on the major benefits, public sector organizations should:

- Align pay and reward strategy with organizational strategy
- Assess the competitiveness and positioning of current programs
- Develop a pay strategy/philosophy
- Close the gap between strategy and programs

Organization and Pay Strategy Alignment

The first step is for public employers to *align their pay/rewards strategy with their organizational goals*. The overall business strategy for the organization must be established: Is it to be the low-cost producer of certain public services? The best in customer satisfaction? Or to maintain the status quo? In any case, pay and reward strategy must be aligned to attract/retain the labor talent needed to carry out the business strategy.

Evaluation of Competitive Position

The next step is to *determine whether pay practices are positioned properly*. This step requires comparison with pay levels in the appropriate labor market. At its basic level, a labor market reflects those organizations where labor talent is recruited or lost. Public employers are in a unique position. While many jobs exist only within the public sector, there are many others that exist in general industry. As a result, public employers' labor markets generally include a broad range of other organizations in the community.

Public employers increase the risk that their pay practices will be misaligned if they examine only other public employers for comparison purposes that share a common structure or role and ignore those organizations that compete head-to-head for the same labor talent. This practice will perpetuate the tendency to underpay positions that require greater technical knowledge and experience or management skills and overpay those that require less knowledge or skill.

Identify Pay Strategy

Once pay has been analyzed relative to the appropriate labor market, public

TABLE 1

Medical/ Dental/Vision	Public Employers	Mid-Size Private Employers
-Employer pays 100% of employee only premium	43%	19%
-Employer pays 100% of employee + premium	25%	9%
-Median individual deductible	\$100	\$250
-Median family deductible	\$300	\$600
-Median physician co-pay (in-network)	\$15	\$15
-Median prescription co-pay (generic)	\$10	\$10
Retirement		
Defined Benefit Pension Plans		
-DB prevalence	77%	52%
-Defined benefit "multiple"	2% x service	1.5% x service
Defined Contribution Plans		
-Employer defined contribution match	3.85% of pay	3.85% of pay
-Employers with both DB and employer matching DC plans	37%	51%
-Post 65 (employer subsidized) Retiree Medical prevalence	59%	47%
Benefit costs as a percent of payroll	35.7%	25.1%

employers must *identify the pay strategy/philosophy* that works best in their highly visible public environment. It will not do to carry on as if it is business as usual.

The pressing needs of constituents to see improved service, cost management, and stronger results demand attracting and retaining skilled labor talent. In recent years, incentive or performance pay has begun to play a more important role in compensation packages across nearly every sector of the American economy, including the public sector. Incentives may offer an effective mechanism for the public sector to provide more competitive compensation while minimizing the impact on fixed costs. While recent events have revealed serious failures in a number of corporate compensation programs, incentive plans are often easier to introduce into an organization than salary management programs like merit pay. The simple reason for this is that incentive plans often use measures that are readily available, highly visible, and automatically credible. Merit pay programs rely on measurement at the individual level where systems and metrics are most difficult to create and manage. In addition, incentives are variable and do not recur if not re-earned. Base salary increases are more permanent: high, fixed compensation is more difficult to defend in the court of public opinion.

A comprehensive pay strategy must include a market definition as well as:

- Desired competitive position relative to that market
- Identification of compensation elements that are appropriate for the organization
- Commitment to regular assessment of the market to confirm effectiveness of strategy and competitiveness of compensation

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Bridge the Gap

Once a compensation strategy is established and current programs evaluated, an organization needs to develop plans to close the gap between what is in place and what is desired. Effective execution depends on:

- **Prioritization:** Effective change-management efforts identify the top priorities for change and tackle those first. Resource constraints, business strategy, costs, and timing all must be factored in as priorities are established.
- **Communication:** Change is difficult for any employee or stakeholder but effective communication can improve the odds that change will produce the desired results. A communications plan—addressing both the immediate situation and the future—must explain the business case for change and ongoing sharing of information about the compensation program as well as employees' roles in contributing to the organization's success.
- **Training:** Training must be for everyone, from management to hourly, from union to non-union. Employees must be equipped to understand and act upon the changes at their level.
- **Evaluation:** Successful change requires systematic evaluation of the effectiveness of new programs and modification as needed to improve those programs.

Case Study

For a large public organization we studied, total pay was competitive: cash compensation was low (2% to 5% below on average) compared to their labor market while non-cash benefits were above average. Rather than continue to increase non-cash benefits, the organization decided to increase salaries while modifying the medical plan to reduce its overall costs. The increase in salary initially made up for the resulting change to medical benefits for the majority of employees. The organization found itself better positioned to manage total pay costs going forward: it could maintain more direct control over salaries than it could over the changes caused by escalating medical costs. The outcome for this organization is stronger control over total pay costs and more flexibility to respond to both the market and employees.

Conclusion

Compensation, incentives, and benefits are a major component of total expenses for most public employers. But they are more than simply necessary expenses. They provide public employers with a competitive advantage when they are aligned with strategic goals and philosophy. They also can ensure that organizations: (1) attract and retain the labor talent necessary for success, (2) manage fixed costs, and (3) create performance and productivity improvements. But in order to be effective, they must be thought of and managed strategically.

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