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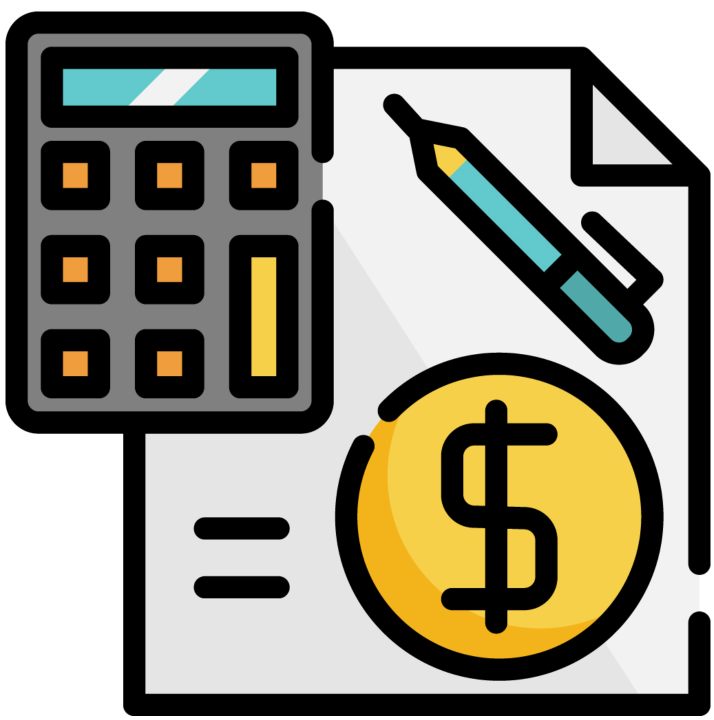
Stretching Your 2019 Salary Increase Budget



Salary increase planning surveys for the United States are consistently reporting a 0.1% increase over 2018, with 2019 survey results ranging from a 2.9% to 3.2% salary increase budget. The movement remains minuscule in comparison to the strength of the economy, lower taxation, the low unemployment rate, pay equity requirements, and the change in the inflationary rates of 2.1% (2017), 2.4% (2018), and 2.1% (2019) according to the World Economic Outlook[1]. With a 0.1% increase to salary increase budgets over last year, it may be timely to reevaluate the methodology for administering your 2019 salary increases.

Consider one or more of these strategies to stretch the 2019 salary increase budget and pay for performance:

[1] *International Monetary Fund. 2018. World Economic Outlook: Challenges to Steady Growth. Washington, DC, October.*

C-Suite Executive Approval

Taking the annual compensation plan to your C-suite executives for approval ensures their support, ownership, and approval of the necessary budget to manage the business for the following year. Consider a twice-a-year C-suite executive review—a preliminary review for planning purposes and a secondary review for final budget approval. Presenting two options for approval to the executive team can provide both a conservative approach and a more liberal approach, should the funds be available to the organization. This also ensures that the executive team is well versed in and supportive of the present and future compensation plan for the organization, pay equity compliance, key compensation challenges, and steps towards resolution.

The annual compensation plan will typically include the following:

- Key recommendations
- Compensation challenges and recommendations for resolution
- Pay equity compliance
- Present market competitiveness
- Future market competitiveness with a recommended total budget that includes adjustments to minimum, cost-of-living or general increases, merit increases, other/equity increases (if budgeting), and promotions (if budgeting)

Merit Carve Out

An effective strategy to recognize top performers can be accomplished by using a merit carve out. Typically, a merit carve out will take 0.5% of the merit increase budget from one population and add it to another population, with the goal of recognizing high-performing employees.

Some companies will even reward these employees at an earlier date than the general focal review schedule. This also supports in recognizing top performers by senior management.

For example, if a company has 1,000 employees with an average base salary of $70,000, and a 3.5% merit budget, the merit pool is $2,450,000. Let's assume a five-tier performance rating scale as follows:

Performance Rating
5 - Far Exceeds Expectations
4 - Exceeds Expectations
3 - Meets Expectations
2 - Sometimes Meets Expectations
1 - Does Not Meet Expectations

By carving out 0.5% of the base salaries for Level 1-4 performers (90% of the workforce), $315,000 can be added to the merit pool for the Level 5 performers (10% of the workforce). The 3.5% merit budget for this group of employees is $245,000, but the additional carve out adds $315,000 to the budget, so the total budget for high-performing employees is now $560,000 (8.0% annualized merit increase budget for the top 10% of the workforce).

A 3.0% merit budget ($1,890,000) is available for all other levels of performance (90% of the workforce).

Example: Merit Carve Out Calculation

Performance Rating	% of Workforce	Base Salaries	Merit Budget %	Merit Budget $	Merit Carve Out %	Merit Carve Out $	Merit Budget with Carve Out $	Revised % Budget with Carve Out
Level 5 - Far Exceeds Standards	10%	$7,000,000	3.5%	$245,000		$315,000	**$560,000**	**8.0%**
Level 1-4 - All Others	90%	$63,000,000	3.5%	$2,205,000	-0.5%	-$315,000	**$1,890,000**	**3.0%**
TOTAL	**100%**	**$70,000,000**	**3.5%**	**$2,450,000**		**$0**	**$2,450,000**	**3.5%**

When an 8.0% budget is distributed among the top-tier performers, the merit opportunity can be stretched significantly, allowing for the consideration of other factors such as placement within range.

Merit Matrix Design

Most companies will reward top performers with a merit opportunity at 150% of average performers, which is often inadequate to recognize top performers and pay for performance. By ensuring the performance distribution is carefully managed in an organization, the merit opportunity for top performers can be increased to 200% or 250% of average performers.

The example below using a 3.0% merit increase budget is a planning tool to support in the development of a merit matrix. When a formula is applied, the average merit spending is displayed, taking into consideration performance ratings, performance distribution, and salary range placement. Once an option is selected, then the actual merit increase guidelines can be developed.

Example: Merit Carve Out Calculation

0-150% FORMULA

Performance Rating	% Occurrence	Under Midpoint: Merit Increase %	Under Midpoint: % Occurrence	Under Midpoint: Formula	Over Midpoint: Merit Increase %	Over Midpoint: % Occurrence	Over Midpoint: Formula	Actual % Spend Based on % Occurrence
5 - Far Exceeds Expectations	10%	4.50%	50.00%	150%	3.75%	50.00%	125%	0.41%
4 - Exceeds Expectations	20%	3.75%	50.00%	125%	3.00%	50.00%	100%	0.68%
3 - Meets Expectations	55%	3.00%	50.00%	100%	2.25%	50.00%	75%	1.44%
2 - Sometimes Meets Expectations	10%	2.25%	50.00%	75%	1.50%	50.00%	50%	0.19%
1 - Does Not Meet Expectations	5%	0.00%	50.00%	0%	0.00%	50.00%	0%	0.00%
Merit Increase Budget	**100%**	**3.00%**						**2.72%**

0-200% FORMULA

Performance Rating	% Occurrence	Under Midpoint: Merit Increase %	Under Midpoint: % Occurrence	Under Midpoint: Formula	Over Midpoint: Merit Increase %	Over Midpoint: % Occurrence	Over Midpoint: Formula	Actual % Spend Based on % Occurrence
5 - Far Exceeds Expectations	10%	6.00%	50.00%	200%	4.50%	50.00%	150%	0.53%
4 - Exceeds Expectations	20%	4.50%	50.00%	150%	3.00%	50.00%	100%	0.75%
3 - Meets Expectations	55%	3.00%	50.00%	100%	1.50%	50.00%	50%	1.24%
2 - Sometimes Meets Expectations	10%	1.50%	50.00%	50%	0.00%	50.00%	0%	0.08%
1 - Does Not Meet Expectations	5%	0.00%	50.00%	0%	0.00%	50.00%	0%	0.00%
Merit Increase Budget	**100%**	**3.00%**						**2.59%**

0-250% FORMULA

Performance Rating	% Occurrence	Under Midpoint: Merit Increase %	Under Midpoint: % Occurrence	Under Midpoint: Formula	Over Midpoint: Merit Increase %	Over Midpoint: % Occurrence	Over Midpoint: Formula	Actual % Spend Based on % Occurrence
5 - Far Exceeds Expectations	10%	7.50%	50.00%	250%	5.25%	50.00%	175%	0.64%
4 - Exceeds Expectations	20%	5.25%	50.00%	175%	3.00%	50.00%	100%	0.83%
3 - Meets Expectations	55%	3.00%	50.00%	100%	2.25%	50.00%	75%	1.44%
2 - Sometimes Meets Expectations	10%	1.50%	50.00%	50%	0.00%	50.00%	0%	0.08%
1 - Does Not Meet Expectations	5%	0.00%	50.00%	0%	0.00%	50.00%	0%	0.00%
Merit Increase Budget	**100%**	**3.00%**						**2.98%**

In the example of merit increase guidelines below, the 0-250% formula has been applied, and a merit percent increase range has been established to support in managerial decision making.

Example: Merit Carve Out Calculation

Performance Rating	% Occurrence	Under Midpoint	Over Midpoint
		Merit Increase %	Merit Increase %
5 - Far Exceeds Expectations - Performance significantly and consistently far exceeds job performance standards.	10%	6.50 - 8.50%	4.25 - 6.25%
4 - Exceeds Expectations - Performance consistently and regularly exceeds job performance standards	20%	4.25 - 6.25%	2.00 - 4.00%
3 - Meets Expectations - Performance consistently and regularly meets all job performance standards.	55%	2.00 - 4.00%	1.25 - 3.25%
2 - Sometimes Meets Expectations - Performance is still developing or does not consistently meet job performance standards. Performance improvement or further development is needed.	10%	1.00 - 2.00%	0.00%
1 - Does Not Meet Expectations - Performance does not meet performance standards of job. Immediate corrective action required.	5%	0.00%	0.00%
Merit Increase Budget	**100%**	**3.00%**	

Automatic Zeros

In this scenario, a portion of the workforce receives zero increases to fund higher increases for stronger performers. Using the same hypothetical company as the merit carve out, Level 1-3 employees paid over midpoint will not be merit eligible to fund a higher merit budget for Level 4-5 employees. See the example below.

Example: Merit Carve Out Calculation

Performance Rating	% of Workforce	Base Salaries	Merit Budget %	Merit Budget $	Automatic Zeros %	Automatic Zeros $	Merit Budget with Automatic Zeros $	Revised % Budget with Automatic Zeros
Level 4-5	30%	$21,000,000	3.5%	$735,000		$857,500	**$1,592,500**	**7.6%**
Level 1-3 Under Midpoint	35%	$24,500,000	3.5%	$857,500			**$857,500**	**3.5%**
Level 1-3 Over Midpoint	35%	$24,500,000	3.5%	$857,500	**-3.5%**	**-$857,500**	**$0**	**0.0%**
TOTAL	**100%**	**$70,000,000**	**3.5%**	**$2,450,000**		**$0**	**$2,450,000**	**3.5%**

Lump Sum Merits

The practice of awarding lump sum merit increases to employees over the salary range maximum is now relatively common. An alternate approach is to utilize lump sum merits for Level 1 and 2 performers and reserve base salary increases for Level 3 to 5 performers. This also generates a larger pool for the top performers.

When considering this approach, be mindful of compression issues, pay equity requirements, and overall market competitiveness. Utilizing lump sum merits too liberally for employees under the range midpoint may be a short-term solution that may not produce long-term results.

Promotions

Since one-half of companies typically budget for promotions, the companies that are not currently budgeting may have an opportunity to budget for promotions to ensure additional funding for promotions. The availability of funds for promotions would then increase, allowing for higher promotional increases while reserving base salary increase funds for performance-related pay.

Conclusion

This is an excellent time of year to consider the methodologies for delivering performance-based pay. Even with limited salary increase budgets, C-suite executive ownership of the compensation issues and requirements will support in stretching the 2019 salary increase budget. The more they understand the company compensation issues, the more likely the C-suite executives may even approve an option to increase the budget!

A 3.5% salary increase budget in this economy in the United States is very appropriate. Whether designing your own approach or applying a merit carve out, automatic zeros, lump sum merits, a redesigned merit matrix, or even promotional budgets, enhancing the methodology to recognize top performers will stretch the limited funds and support in retaining critical, high-performing employees. New and revised programs should always be well communicated to both managers and employees alike to support in managing expectations throughout the organization.

Determine the Market Salary Range for Any Position

Please email Linda Cox at linda.cox@erieri.com with questions or comments.

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