Pay Scale Development and Implementation

American College of Medical Practice Executives
In Partial Fulfillment of the Requirements for Election to ACMPE Fellow

Case Study Submission #3

August 26, 2015
Introduction

In the fall of 2009, when the Great Recession started to strangle state coffers, the Chief Executive Officer’s (CEO) community health center (CHC) experienced a cut in Medicaid funding and other state grants in the amount of $1,000,000 (out of $19,000,000 in total revenues). As a result, the CHC suspended staff raises in 2010. The pay system at the time had two elements: 1) a seniority-based “step” system that increased pay 4-7% every two years, and, 2) variable cost of living raises (COLA) as approved by the Board, annually. Step or COLA increases were not implemented due to fiscal constraints. The state funding cuts continued but modest COLA raises were awarded in 2011 (no “step” increases). As 2011 approached, it was clear the CHC would have a hard time adhering to the current system. Therefore, the CEO assembled his executive management team and re-evaluated its pay philosophy in order to guide the development of new pay practices.

Re-assessing the CHC’s pay system was imperative for four reasons. First, the organization could not afford to catch-up on the step increases that had lapsed. Second, the step increase plus a cost of living increase system was not financially sustainable in the long-run. Third, staff was not clear on how to earn raises and dissatisfaction was starting to take root. Finally, the CHC wanted to maintain its position as a competitive employer when the economy started to grow again.

Failing to address these issues posed significant risks to the CHC. First, the CHC enjoyed a high level of employee retention and satisfaction. A lack of clarity about pay practices, particularly the step system remaining in limbo without a concrete replacement system, threatened to increase the turnover rate. Higher turnover would threaten quality
care and good customer service. Second, new organizations (i.e., hospitals, mental health center) were starting to enter or expand into primary care, the CHC’s service line, and the CHC expected to experience increased competition for staff. Finally, the CHC needed a pay system that was financially viable and provided more flexibility to respond to employment needs. The CEO worked extensively with his executive management team, Human Resources Director (HRD) and the Board to assess how the CHC could update its compensation system to respond to these challenges.

**Alternatives Considered**

The CHC has two classes of employees with respect to its pay practices. The first category is “contract” employees, which includes professional staff (doctors, dentists, therapists, executive administration). The second category is “non-contract” employees and includes support staff (i.e., medical and dental assistants; clinic and administrative support, middle management). This case focused on the pay practices for ‘non-contract’ employees. Contract employees pay is re-negotiated upon renewal.

**Alternative #1 Maintain a Seniority and COLA Oriented Pay System**

Staying with the current system was a non-starter for the reasons mentioned in the Introduction. However, it is helpful to analyze the status quo as a basis of comparison to other options. There were several features to the current system that were desirable. For example, it was objective, familiar and understood by staff, management and the Board of Directors. It was transparent to staff with respect to how the CHC administered pay.
The system was also straightforward to administer for human resources and payroll staff. Finally, the current system was predictable and facilitated budgeting and cost analyses.

However, the current system was judged to be unsustainable. Cost was the main factor in this determination. The step system was implemented in the mid-1990s in order to reward employees for length of service. This system was successful; the CHC consistently had turnover rates (approximately 16%) less than its CHC peers in the same state (19%)\(^1\) and the health care sector in general (19-28%)\(^2\). Since two years had lapsed since step increases were awarded, every employee with two or more years of service had not received this increase. To resume using the step system, about half of the employees—about 90 full time equivalents (FTE)—would need two step increases and the other half would receive one step increase if the system was applied as intended. The cost of resuming *only the step increases* was significant. Here is an estimation of the impact using average hourly wages and median average step increases:

- Incremental cost of **one** step
  - 90 FTEs times [$15.00/hour X 5.5\%] times 2080 = $154,440

- Incremental cost of **two** steps
  - 90 FTEs times [$15.00/hour X 11.0\%] times 2080 = $308,880

- Total incremental cost of “catching-up” = $463,320

The cost of catching up would add three percent to the total cost of personnel expenses, which for the CHC would prevent it from being able to add needed personnel, manage the cost of benefit increases and resume the step and COLA pay system. The organization could not pay this bill within the context of its overall budget.
Another limitation of the current system is that it rewarded employees regardless of performance. Longevity benefited the organization and there was still an interest in placing value on it. However, the CHC was interested in positioning the organization for increased performance expectations by funders and payers:

- Seventeen percent of the CHC’s funding was received from the U.S. Department of Health and Human Services and the CHC is accountable for utilizing the funds cost-effectively; the CHC is compared to its peers\(^3\).
- The Medicaid program in the CHC’s state implemented a primary care oriented, accountable care collaborative in 2011 to initiate delivery and payment reforms. The CHC participated in the collaborative and had shared savings opportunities as well as financial support for improving its patient-centered medical home model\(^4\)

Maintaining the current system would forfeit an opportunity to use pay practice strategically to support organizational performance.

*Alternative #2 Adopt a Market-based Pay System*

According to a 2012 survey conducted by the Society for Human Resources Management, market-based pay systems have emerged as the most common approach (64%) for setting wages\(^5\). For this case, market-based pay was defined as setting wages relative to what other employers, regardless of industry sector, are paying for a substantially equivalent job. A pay system that is exclusively “market-based” only considers price for labor at given levels of supply and demand and doesn’t factor in other variables when setting wages such as the value of seniority.
Theoretically, a pure market-based approach should result in the lowest cost to procure a sufficient supply of staff for a given demand. Thus, a benefit of the approach is to conserve personnel funds. It is a form of strategically allocating personnel funds whereby the CHC could invest more salary resources into high demand jobs and conserve funds for jobs for which there is a sufficient or, even, over-supply. The result is employees with skills and experience in high demand are financially rewarded and the employer avoids losing needed staff to employers who have the same need. The market-based approach would also be financially sustainable because the CHC would retain control of the rate of wage increases because it would define the market in which it would compete for staff.

There are two considerations when shifting to a market-based system that could be considered drawbacks. First, a greater effort and cost is required to administer a market-based system. The quality of the system is dependent on current, comparative wage data. While some wage data is available at no cost at many web sites, the best data is available from subscription services. Human resources must periodically evaluate pay levels (i.e., annually) or when certain positions are hard to fill. This is an incremental effort to a system in which raises are on “auto-pilot” with a step system.

The most significant risk is the potential for dissatisfying employees used to “predictable” raises who serve in positions in which market wages are not increasing at a rate to match expectations. A market-based system inherently results in variable increases in wages from one position to another because the supply/demand varies for different jobs. For some employees, receiving a smaller raise than a co-worker may engender resentment and lower morale.
Alternative #3 Adopt a Modified Market-based Approach

The “pros” and “cons” of this alternative include that which was identified for the second alternative. This option, however, isn’t a pure market-based approach. Rather, it combines aspects of the market-based approach and with aspects of the current system that continue to have value. Specifically, the executive team identified longevity as a characteristic it still wanted to reward in the pay system since it supported quality, long-term interpersonal relationships with co-workers and patients and, in turn, better customer service.

The desirability of the third alternative is it could provide a way to transition the organizational culture and understanding of CHC’s pay practices from the step system to an updated pay system. Specifically, this option gave management the ability to give relative weight to the market and seniority based on the pace at which it wanted to change pay practices.

Chosen Solution

Procedures Used to Select the Solution

Regardless of the pay system an employer chooses, it should be rooted in a “pay philosophy.” A pay philosophy is a guiding document that provides the principles on which the organization wants to administer its pay practices. In addition to providing overarching goals for pay practices, a good pay philosophy supports the strategic and business goals of the company, and reflects the culture and values of the organization.⁶
For example, several goals and values were previously mentioned as important to the CHC and are summarized below:

- Business goals included driving performance improvements with pay so the CHC could participate effectively in payment and delivery reform.
- The CHC Board set a strategic goal to be sustainable and financially independent.
- Core values such as integrity, quality and customer service needed to be evident.

The CEO worked with his executive team and Human Resources Director (HRD) to establish a pay philosophy to guide the development of an updated pay system based on these principles. This was accomplished in a mini-retreat in which the Clinical Officers, CFO, COO and CEO participated.

There was a strong desire to utilize market-based pay. Sustainability and affordability were a driving factor but, just as importantly, the management team believed the CHC’s services were as good as, or better than, comparable services. Thus, if the CHC was providing ‘market’ competitive services then it would follow that its staff should be paid according to the market. This was a powerful conclusion because it helped the CHC transcend economic reasons and attach the philosophy to the organization’s culture (i.e., integrity) and aspirations (i.e., quality care).

The executive team wanted to retain the use of longevity in the updated pay system since achieving a low turnover rate was a business goal of the CHC. Seniority would no longer drive the rate at which employees received increases but it would
continue to include longevity in the system by paying higher wages to longer serving employees in the same positions as employees who had less tenure.

**Decision**

The first alternative was dismissed as unsustainable and unaffordable. The CHC could not continue to sustain automatic pay increases according to a rigid scale. However, the current system did have elements that would be valuable to carry on.

The second alternative wasn’t chosen because it lacked the ability to incorporate the CHC’s core values, which help drive organizational cohesiveness and performance.

The third alternative was chosen because the CHC could attain the advantages of market-based pay but control the titration of transitioning from a seniority system to a market-based pay system.

**Implementation**

The pay philosophy was utilized by the HRD to design a new pay system. A human resources consultant was engaged to assist with research and pay system design. The CHC was a member of a regional employers’ council that provided these services and the council possessed a robust database of salary surveys in the labor market in which the CHC operated. Over the course of several months, a work group of the HRD, COO, CFO and CEO created a new scale and a methodology for determining raises.

The manner in which the new system was blended to account for market-based pay and rewarding longevity was manifested in the following manner.

- The median pay for each job was used to set a midpoint salary range.
• The low end of the range was set at 80% of the median and the high end was set at 120%.

• New employees would be hired within 80-85% of the median, and supervisors could recommend up to 90% of the median if the position could not be successfully filled, or, the desired person had a distinguished characteristic the CHC needed such as a skill or relationship that the CHC doesn’t possess. Someone who was hired at 80% of the median would reach the median within 5 years.

• The midpoint would be updated annually based upon a market survey utilizing a pay data subscription service subject to the budgetary

• In the first three years of implementation the majority of the raises budget would be prioritized this way:
  o Employees who were paid below 80% of the median were given raises to bring them up to the minimum.
  o Employees with longevity who “fell behind” secondary to the recession’s impact on the CHC’s salary budget, would receive a disproportion increase so as to place them on the range to meet the goal for five years of service to be at the midpoint.

A financial analysis was conducted by the team preparing the operating budget. The budgeting process determined a budget for compensation increases and would be allocated according to the modified, market-based pay system. The selected option was integrated into the annual operating budget. The new pay system was presented to the Board Finance Committee, and then forwarded to the full Board of Directors for
approval. The new system was communicated to the employee population, and supervisors were given a report for each employee they supervised that explained the methodology used to award the employees’ raise.

**Significance of Outcomes and Lessons Learned**

Employees desire a pay system that is well-defined and predictable. The CHC achieved predictability by setting its wages relative to similarly situated employees in other organizations. For example, a receptionist at the CHC would be able to expect that his or her pay would not vary significantly from the pay offered by a business seeking to hire receptionists. The CHC wanted its employees to conclude that it was paying them fairly, with “fair” being defined as good, or better than, their employment alternatives. As illustrated in the Chosen Solution section, the CHC was able to articulate to staff how it would administer pay in the future. This was a function of developing a pay philosophy and clearly defining how market data combined with longevity rewards would be applied.

The desired outcome of an organization’s pay practices should be allocations of personnel dollars that help a practice achieve its strategic goals. This is critical because personnel dollars are the single largest expenditure in a practice and most important resource for delivering high quality care. If pay practices are driving strategic and business goals then the practice will, hopefully, enjoy a return on this investment that will fund future personnel needs, including rewarding employees for their contribution to the organization’s mission.
Changing pay practices requires significant research, communication and, ultimately, a culture shift. The CHC in this case benefited from engaging compensation consultants to support its research. A focus on pay philosophy development generates copious discussion about the values the organization wants to support through pay practices. If this discussion is thorough, the organization will be able to communicate its pay practice system effectively.

**Recommendations for Other Managers**

Using a financial challenge, such as funding cuts, provided an opportunity to evaluate and update a critical system, i.e., pay practices. Sharing with staff that the organization needed to be sustainable in order to pay fair wages was intuitive for them to understand. While the CHC did have staff who lamented the conclusion of the step system, most staff gave the organization credit for getting out of the holding pattern in which the lack of clarity about how raises would be administered was a negative force.
Endnotes

5 https://www.shrm.org/resourcesandtools/hr-topics/compensation/pages/pay-structures-shift.aspx