A Unique Finding from ERI
COL Impact Up, Merit Pay Down?

Area Differentials Appear More and More Affected by Cost of Living Changes
Does This Mean Merit Pay/Performance Appraisal Links Are Dying in America?

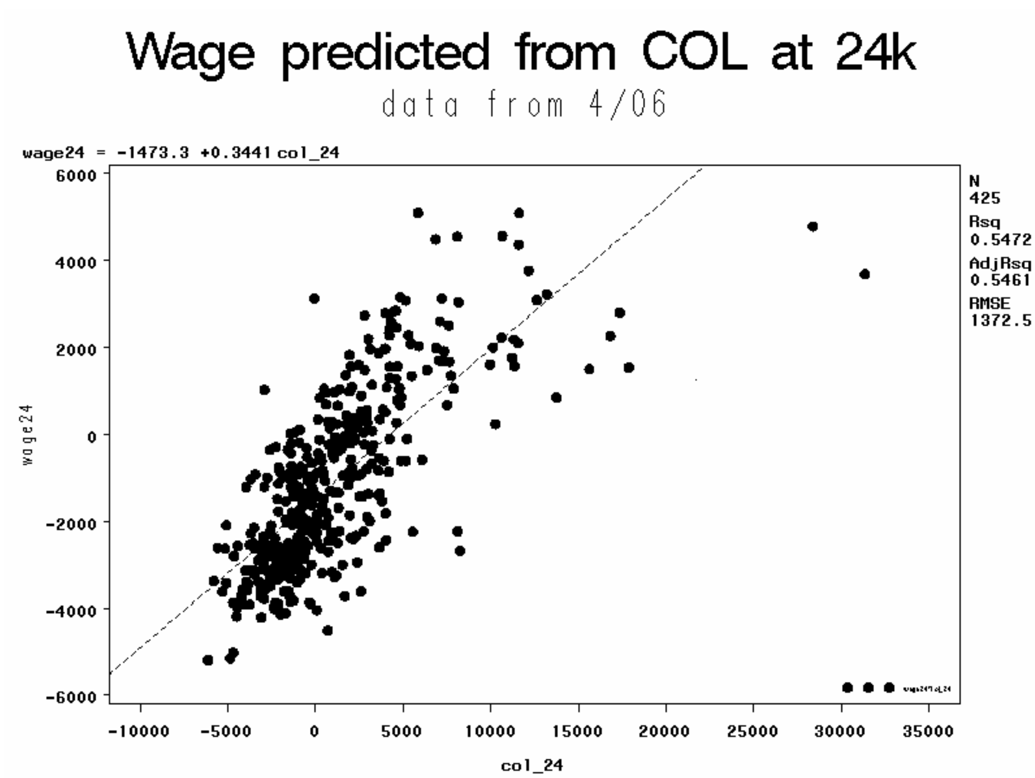
Area wage/salary differentials reflect the demand and supply of labor. Area cost of living (COL) differentials reflect the demand and supply for goods and services (housing, taxes, consumables, services, transportation). **Geographic Assessor** data reflect the former, **Relocation Assessor** data the latter. ERI researchers have been studying, reporting, and selling subscriptions related to differentials since 1976. Thirty years ago, the relationship between salary and COL variances* were explained by correlations of .30. Today that correlation is at .74 and this trend may well reflect changing salary increase practices.

GA Diffs versus RA Differentials @ $48,000		
Year	**Correlation**	**R^2**
1994	**0.34**	**0.12**
1998	**0.58**	**0.34**
2002	**0.72**	**0.52**
2006	**0.74**	**0.55**

*This study of variances is explained, for example, at points of $24,000, $36,000, 48,000, 72,000, etc.

	Wage/Salary Variances						Cost of Living Variances					
	10714	24000	36000	48000	72000	108000	10714	24000	36000	48000	72000	108000
UNITED STATES AVERAGE, U.S.	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
AKRON, OH	83.	-912.	-766.	-422.	963.	1635.	188.	-212.	-43.	126.	582.	539.
ALBANY, NY	243.	305.	915.	1506.	2639.	3848.	2115.	3378.	4924.	6470.	9062.	13986.

Graphically, this review can be explained as:



Correlations of .74 and R-squares of .54 explain about one-half of what is occurring (square for the multiple correlation) in variance relationships, although that relationship may not be causal. That said, evidence exists that the relationship between salary and COL differentials is increasing. Whether this is a "good or bad" depends upon one's views, how social concern is weighted against competitive dynamics, and whether this change is causal or by chance. ERI tends to favor the latter view (this is not an economically healthy trend), but ERI is most interested in why this relationship exists; why it has increased, and why in recent years, the delta seems to be accelerating. In talking with ERI's 7,000 subscribers (24/5 Subscriber Call Center, San Francisco Subscriber Conference in April 2006, etc.) and reviewing the data at all earnings levels and for all years (beginning with an old Compensation Institute 1978 Geographic Differential Report and the abandoned US Urban Family Index), the following hypotheses have been proposed (ERI does not necessarily agree with these suggestions, many require in-depth study; all, however, are thought-provoking):

- *Management has allowed employees to influence these discrepancies: wages sustain life, COL sustains a lifestyle.*
- *Salary administration once was a management cost control function; today it is a social concern, once a year, illustration that one has taken note of all the newspaper articles sent to the department.*
- *Shifts in industries (US manufacturing now in the single digits as a % of the economy) have new dominant SICs that traditionally favor COL (government, public sector) adjustments.*
- *Salary administration in the US has lost its cost control discipline; we'd rather close offices/plants than manage salaries.*
- *Freezes in salaries in low cost areas have accelerated the delta (as freezes are atypical in high COL areas).*
- *As ERI now finds clear evidence that major increase amounts go to certain job functions, the rest may be receiving COL solace.*
- *Firms are less reliant on salary surveys than in the past; many now opt out for easy, COL muting of squeaky wheels.*
- *The past 10 years of low COL increases have made it a convenient benchmark for low, but nominal-appearing, increases.*
- *COL, once used, becomes a self-fulfilling prophesy; it is a habit that is tough to beat.*
- *States where costs high are adopting minimum wage laws and this has to affect differentials.*
- *Once a COL precedent is set during a time of low inflation, it's difficult if not impossible to disengage when COL accelerates.*
- *Cities where costs are high are also adopting Living Wage laws reflecting COL and these too are reflective.*
- *Variable pay plans may be explaining differences, base salary is more easily increased by COL/general increases, merit variability is being replaced by start/stop use/lose incentive mechanisms.*
- *Loss of interest in/ability to defend "pay for performance/appraisals" makes COL an easy escape route. As society becomes more litigious, easier to treat everyone alike.*
- *Merit pay creates winners/losers, makes enemies; COL is win-win with no hard feelings, makes managers popular and never having to deliver bad news to the ½ of the populace receiving less than average increases. (There's a reason why comp people go to lunch in threes.)*
- *Executive increases (which used to be bi-annual) are now annual and top management has to assure that COL is at least covered.*
- *HR/Comp Managers are now "process focused" rather than analytically focused: "process" leads to negotiated COL increases. Process/negotiation based people have tougher times telling mid-level and below-average performers the truth; easier to lie with a COL increase.*
- *Once COL increases are agreed to and used, it's all but impossible to retract or not use the next year. Even top managements expect their COL increases once they are put in place.*

- *Managers are unknowingly using free web data Salary Calculators that are COL, not wage differential, comparisons.*
- *And other free web sites, where no evidence of the massive research needed to provide the results reported – ie., they are "guessing," may be "blue skying" numbers pleasing to employees, taking into account the COL of an area.*
- *As more jobs are found in government, service and health care, union/negotiated annual COL increases are determinative.*
- *It is easier to give into COL increase demands in the workplace and then close the office/plant and move it to India/China.*
- *One doesn't have to justify COL increases (or lack of) more than once; they are easy to manage/administer/communicate.*
- *One doesn't have to have a trained compensation staff to explain COL increases; they have low impact on HR's effectiveness, makes HR seem knowledgeable, etc.*
- *Corollary, one doesn't need a compensation staff, if all one does is give out COL increases.*
- *Gives logic to statistical finding: the best predictor of a worker's pay is his/her entry level salary.*
- *If America is losing its place in the world, US workers will live poorer; to be poorer costs have to increase faster than wages; COL increases defined as (excluding interest and/or energy) can assure this. For certain, they will assure wage increases never greater.*
- *How else can one engineer a lower standard of living: COL increases have to exceed salary.*
- *Health benefits are chewing up huge increase in payroll $'s, COL increases exist to minimize employee contribution increases.*
- *Give COL increases and take that issue off the table; forestall union/other incursions/table the topic of salary increases.*
- *Pay for performance and variable pay cause too much grief, it is easier to give COL increases.*
- *Health benefit increases have eaten up what used to be merit budget pools.*
- *Low COL increase rates have given an easy maximum cap to wage increases that has been gratefully used by management.*
- *COL are for the masses, high and frequent increases are for the "super keepers," merit pay is for the masochist.*
- *Salary Administration has shifted to line management who are untrained in salary increase methodology.*
- *Evidence exists that Canada/UK/Europe have further "advanced" COLitis disease conditions (China, India and Indonesia do not).*
- *The relationship has accelerated in recent years; during this period salary increases have run ahead of inflation; now the screw is about to turn.*
- *For the most part, the areas with high relative pay are the more crowded, rapidly growing areas; that is, the higher cost areas. This phenomenon is limited to the obvious geographic areas: SF, LA and the DC-Boston corridor. But with all of the organizations based in those areas, it drives up the correlation.*
- *Several major corporations now have locality pay add-ons in high pay areas. That practice was non-existent in 1990s. The fact that these companies have so many employees and so many branch offices/locations, drives up the effect.*
- *It is not COL that is the driving force, it is the cost of energy and housing prices, unique components of COL that are causing this damage.*
- *This is why many salary increase surveys miss the real projected movement by .1% or more; companies aren't reporting the "social concern" driven increases they are giving in certain areas of the Country tied to cost of living make-ups.*
- *Salary $'s don't come from printing presses, increased prices equate to increased revenue and compensation, but employee benefit costs are the rotten apple that has spoiled the merit increase*

pool; the biggest cost increase dictates conservative salary increases.

In summary, changes in COL and the rate of change have a higher predictive value than what ERI (or other writers/researchers) would traditionally have expected. None of the above observations are a proof, they are simply what they are: interesting observations. In the social sciences, a correlation above .50 is of interest, but in the real world one looks for correlations of .90 or higher. The .74 is perhaps not worthy of notice. But what's of interest is the change in the relationship over the 1970 – 1980-1990-2000 and now 2006/2007 time periods. The trend's direction of .30 - .50 - .70 is what captures one's attention. Since the period prior to 1994 was basically stable, the recent 12 year period, which coincides with America's increased use of variable pay plans, is of even more interest.

The other major finding/observation from ERI databases are the increased differentials in pay increases between and among job functions. Not all types of jobs are increasing at the same rate. If they did, one would only have had to purchase a salary survey in 1991 and increase all jobs at the same rate. How this phenomenon fits in with the increased correlation between salary and cost-of-living differentials is unknown.

For private industry, this may have little impact. Surviving and thriving organizations will always reward for performance, retain and motivate their key performers, and beat/best their local and international competition with their human capital. But what this may show is that managers who believe that salary administration and budgets as one of the few variables that management can control and use for strategic human resource purposes are losing those battles. One wonders if that means performance appraisals linked to merit increases are also on the wane.

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