Geographic Pay Differentials

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Abstract
The mathematical application of geographic differentials to market pay data is useful to overcome gaps in survey coverage. Conventional compensation practice is to apply geographic differentials to national data when a survey does not report data for your particular geographic location. This paper discusses the practice of applying geographic differentials when market pay data is unavailable for a specific location.

Geography is a factor that influences pay levels for a given job. The physical, geographic location of an employee’s job is a consideration when determining employee pay practices.

The cost of living in an area and the geographic pay differential are not the same analytic. The two tend to be related, but cost of living describes the cost of goods in one location relative to another, whereas geographic pay differentials describe the cost of labor in one location relative to another.

How Geography Influences Pay
Compensation professionals will recognize that market pay for lower-paid and lower-level employees vary more with geography than for higher paid and more senior employees. Consider that the recruiting market for executives is national—or even global—whereas the recruiting market for administrative support personnel, for example, is typically local. Executive jobs are often single incumbent jobs and, therefore, require fewer candidates from a broader recruiting market to staff. Lower paid jobs are more likely to be multiple incumbent jobs that are staffed from local recruiting markets.

How Geographies Compare
Some of the highest paying areas in the United States are the ones you’d expect: New York City area including nearby parts of New Jersey and Connecticut; San Francisco Bay area including Silicon Valley, San Jose, and the East Bay; and parts of the greater Los Angeles area. There are also those, obvious, but sometimes forgotten high salary areas like Anchorage, Juneau, Fairbanks, and Honolulu. These areas also have, indeed, narrower economies, so there aren’t as many career opportunities there.

Some areas like Alaska have to pay a premium because of the cost of living and the remoteness are not appealing to many people. As a general rule, however, cities and their surrounding suburbs pay more than rural areas.

Some of the lower paying areas, in general, are Brownsville, Texas; Laramie, Wyoming; Las Cruces, New Mexico; and Pierre, South Dakota. And to round out the group, some places where pay is fairly close to the national average are: Carson City, Nevada; Cincinnati, Ohio; Duluth, Minnesota; Harrisburg, Pennsylvania; Racine, Wisconsin; Toledo, Ohio; and Utica, New York.

When To Apply Geographic Differentials
Geographic differentials are more pronounced at the lower levels of an organization. Employers generally recruit for lower paying jobs from the local population, so they are recruiting based on the local pay practices. More senior-level positions tend to spread a broader net for their recruits with broader pay comparisons — that is, less geographically specific. Consider that executives and other higher-paid employees use most of their compensation for non-local expenses. That is, they buy vacation homes, boats, pay college tuition, and invest in the stock market (or other investments). These expenses are independent of geography; therefore most of their compensation also tends to be independent of geography. There are also certain jobs and job categories whose pay are geographically linked but in a different or more pronounced way than the more general geographic differentials. For example film producers, directors and actors are on average better paid in Los Angeles and New York than elsewhere. The difference is more pronounced in this case than just the standard geographic pay differentials. Similarly, industries like fishing, farming, natural resources, and the like, all have geographic hot and cold spots. It’s also worth noting that higher-level employees often use the geography as a negotiating chip. Regardless of the two cities involved, executives may try to justify needing more pay in the new city. If the new city is more expensive, cost-of-living is the reason; if the new city is less expensive, the argument becomes loss in status warrants a higher pay.

Factors To Consider
There are a number of factors employers typically consider when determining whether or not pay rates vary from location to location. Cost-of-living is just one factor, as mentioned above. Another factor is the likelihood and frequency of employee movement from location to location. If employees are moving back and forth among locations, there could be both administrative and communications problems around changing pay levels every move. Moves that generate pay increases are not usually a problem, but moves that create pay decreases are more difficult. Perhaps the most important factor is the cost of that particular set of skills in the local market. If you need to pay more in another location to get specific quality and skill of workers, then that often dictates your company’s pay practices. Similarly, if
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you can pay less for the required skill-set, that can help boost profits. Some companies leverage the lower cost location by “overpaying” their employees to attract and retain the best possible workers in the area. This can effectively create wage inflation and eventually, those high payers, if they employ enough people, will re-define the compensation market for those jobs. In 2002, Microsoft eliminated a 25% pay differential they had added to compensation for employees who worked in the San Francisco Bay Area. They paid this differential to certain skilled engineers for several years to attract and retain the best people in a very hot recruiting market. As the dot.com bubble burst, it became evident that they no longer needed to pay premium wages because a glut of top-notch talent became available. Two or three years ago, as lawyers were fleeing law firms to work for their dot.com clients, Skadden, Arps increased the salaries of their New York attorneys and then made the decision to raise all other lawyers’ salaries to the new New York City rates. This in effect, recognized that these people had the same skills and were delivering the same service, regardless of location. It also allowed New York lawyers to be transferred to other Skadden offices without taking a pay cut.

When to Apply Geographic Differentials

Whether or not geographic pay differentials are appropriate depends on the jobs in question and the organization. The number of employees, the number of locations, the variety of the locations, the type of work being done in each location, should all be taken into account. For simplicity, an employer with a primary location in one city and a small satellite office in another, could set the pay in the secondary office equal to the pay in the primary office (assuming market rates in the secondary office’s location are lower). With a small second location, it’s sometimes easier to just include those employees in the same pay ranges as the primary office. If, however, the secondary office were in a more expensive area, most companies would pay those people their appropriately higher wages, because they otherwise couldn’t compete for employees. Organizations with multiple, similar locations will often set a corporate pay policy that sets the pay standards company-wide.

The compensation or human resources departments in certain locations can be given premium pay allowances — usually denominated as a percent above the company standard — for various groups of employees. Other organizations with multiple locations will determine all their pay practices based on the local compensation market. Historically, this has been difficult because of the dearth of local pay data. Employers now have more of this local data available via resources like Salary.com’s Compensation Market Studies (http://cmssalary.com) that allows them the ability to use local pay studies to set their local pay practices.

Geographic Discrimination

In general, an employer should be safe from criticism of discriminating compensation levels by geography if all employees are paid according to a standard set of rules and protocols — even if that set of rules uses local market data for each location in which lower pay for women or minorities exists. If this does happen, even as a result of a fair and unbiased process, the employer should take note. A fair and unbiased process does not prevent accusations or lawsuits. At a minimum, the employer should be sure to know that a discrepancy has been created as a result of the combination of the gender or racial composition of the labor markets and the local labor market pay practices.

Employers may face charges under federal laws prohibiting job discrimination regulated by the U.S. Equal Employment Opportunity Commission. All of these laws hinge on the intent of the employer in determining pay practices. For protection against potential claims from Title VII of the Civil Rights Act of 1964 (Title VII), which prohibits employment discrimination based on race, color, religion, gender, or national origin, it is important for the employer to determine the compensation rates of “similarly situated” employees — market compensation rates. Employers should at all times be comfortable that their pay practices are based on nondiscriminatory factors.

The Equal Pay Act of 1963 (EPA), which protects men and women who perform substantially equal work in the same establishment from gender-based wage discrimination, permits pay differences if they are based on seniority, merit, quantity or quality of work, or any factor other than gender. It is the employer’s burden to prove these affirmative defenses apply, but if the apparent discrimination is a result of reasonable geographic pay differentials, then the argument should be defensible. The EPA focuses on pay within an “establishment,” which generally means a single physical location — not all employees working for the employer. There are some situations where multiple locations might be considered one “establishment” but it’s unlikely they would be in areas far enough apart that employees would be truly paid different wages because of their geographic locations. Title VII is probably a bigger exposure because the requirements for “discrimination” are less definitive than the EPA.

Communicating With Employees

Employees generally equate cost-of-living with pay practices. Explaining that pay in different locations is determined by labor market prices (i.e., not shopping market prices) particular to that city or region will make intuitive sense to employees. Problems will arise when an employee relocates to a lower paying location if the employer wants to adjust pay to reflect the local practices. Some employers leave the employee’s pay at its higher level. Other employers cut it immediately to the appropriate lower level. Of course, others will transition the employee by, for example, converting the difference into a bonus in the first year, and perhaps half that amount in the second year. Employers who face this issue should codify their pay policies so that all executives, managers and human resource people are “on the same page.” Managers should not make promises to employees or recruits without understanding the company’s pay policies. It is important to note that cost-of-living and geographic pay differentials are not always equivalent. Our cost-of-living calculator (http://costoflivingwizard.salary.com) illustrates the difference between the two variables.

When To Use National Data

Employers most often do use national market data for high-paying jobs, but this practice is not necessarily for all jobs of $100,000 or more (or any other arbitrary cut off). The
question is really whether the job normally recruits nationally or locally. We would suggest that a pay cut off is probably closer to $150,000 or so. This is because $100,000 isn’t as much as it used to be and there are now a fair number of jobs that are around the $100,000 level that are not necessarily senior positions. The people in these roles are likely to see a positive geographic differential when moving to an expensive area. Also, vis-à-vis the comment earlier about how pay is used, people living on $100,000 per year are still using a substantial part of their income for local expenses (e.g., housing) and as such would expect to see their pay fluctuate based on geography.

Managing Geographic Differentials

Employers deal with multiple locations in every way imaginable.

- Some use the “peanut butter approach”, that is, spread the pay evenly over every location.
- Others use geographic differentials by using a factor for select locations.
- Still others use actual market data for each location.
- Some set a pay practice based on a corporate pay scale and use an “up-factor” for more expensive locations.

The decision of how to deal with the situation is primarily based on the overall corporate compensation philosophy.

- Organizations whose locations operate as somewhat independent, autonomous units will often allow them to set their pay levels how they see fit. This generally translates to each location paying based on the local competitive market.
- Organizations that want people to move freely from location to location tend to have less pay disparity between any pair of locations.
- Organizations with most locations situated in similar types of locations with a small number of facilities in much higher paying areas, often provide premium pay to those who work in the higher paying areas. They communicate clearly that this practice is reserved for those select locations. People moving to them often see the premium as a line item in pay package as a constant reminder that this is just in effect while they are in that location.

Employee Relocation

If an employee quits a job in one location and moves to another location, his/her new job will most likely pay at the going rate in that new location. Employees transferring within an organization often experience the same scenario for the same reasons. An employee moving from a higher paying location to a lower paying location may use the former pay level as leverage to negotiate a higher pay in the new location. This can be effective if there isn’t sufficient documentation of the rationale behind the former pay level. The employee may claim that all or part of the difference is attributable to skills and performance, rather than geographic differentials. This tactic can be most effective when changing employers, but it can also work for internal transfers if the compensation documentation is unclear or absent. Employees moving from a lower paying location to a higher paying location are generally accommodated if the move is a transfer within an established business. Employees who are changing employers in this situation sometimes overlook the pay differentials, or misunderstand them, and accept salary offers that are lower than they could have received, or set unrealistically high expectations of salaries in the “big city” based on pure cost-of-living comparisons (rather than geographic pay comparisons) or based on gut instincts of the relative costs of the living in the new location.

Occupational Anomalies

Physicians often receive substantial subsidies to locate their medical practices in rural areas with underserved populations. More commonly, we see employers locating businesses in areas where relatively inexpensive labor is available. In such cases, subsidies often go to the employers in the form of tax breaks. We can’t overlook things like the Federal Government’s farming subsidies. These are effectively pay hooks to get people to perform certain jobs in agrarian locations. A variation is that technology companies in cities such as Austin, TX would pay salaries comparable to the Bay Area but the cost of living is considerably cheaper. Rather than using pay as the hook, they would use a “real dollars” comparison to show that the value of their pay was significantly higher. Another variation on this theme is the concept of building certain facilities in low cost areas for work that can be done anywhere. Call centers are a good example of this phenomenon. Call centers can be located anywhere, so places like Manhattan and downtown San Francisco don’t make as much sense as in the Midwest or Florida, where salaries for those jobs are much lower. (Incidentally, it’s worth noting that those call centers that moved to Florida are now moving off shore to places like India where the cost of call center labor is still significantly cheaper.)

Obtaining Geographic Differential Data

Salary.com has up-to-date market compensation covering thousands of jobs across more than 180 metropolitan areas. Be sure information is current. A compensation survey that is dated “2002/2003” might actually have data effective in January or February of 2002. This data is no longer current. Similar to the point above, use caution with “predictive” surveys. Surveys that ask human resource professionals what they “expect to pay” should be used as just that—indications of expectations, not of reality. This is not to imply that any participants would purposely mislead the survey publisher, but they do not all know what the future will bring, and often, external events that occur after the survey will have an unexpected impact on the company and its plans. Some employers find the best source of local market data is the local market. Employers actively involved in recruiting get a sense of the market in real-time. The problem with this approach is that sometimes an employer loses a candidate because the initial offer was too low, or wins a candidate
because the offer was too high. Employers should collect several sources of information to assure that they have an accurate, unbiased view of the market. If you’re having a difficult time getting information for a specific job, look for other positions that are naturally related to the job in question. See how pay practices for the group compares from one location to the other.

Impact of Unemployment on Geographic Differentials

Certainly geographic pay differentials for certain areas have subsided from their late 1990’s highs. Perhaps the most obvious “rebounding” has taken place in and around San Francisco, San Jose and Silicon Valley. Although salaries in these areas are still higher than most other parts of the country, they have come down to levels more comparable with the rest of the higher paying areas. As time goes on, certain metropolitan areas become larger economic forces while others become lesser economic forces. As the relative economic importance of various cities change, the geographic pay differentials will likely also change. The recent economic downturn has started to have some effect on reducing the pay disparity between geographic areas in the country. Reduced pay disparity is a result of softer U.S. job markets, but some of it is a secondary effect from the cost of living effects of the weak economy on expensive areas. The most recent economic downturn has had a greater-than-normal impact on the economy major cities and the pay of white-collar employees. This is starting to have an impact on the costs of living nationally, which may eventually equalize the pay of the lower level employees across geography.

Conclusion

Because current, accurate, local compensation information is more readily available now than ever before, employers are more likely to calibrate pay for all employees by location. As long as there are significantly different costs of living among metropolitan areas in this country, there will be geographic pay differentials. Employers have profitability reasons to pay the lowest rate possible to employees, which are counterbalanced by the continuing push by the workforce to maximize their income. Perhaps more simply put, the law of supply and demand will continue to create a true market for compensating each given job in each location. That said, as more cities grow and rise to the compensation levels of the larger cities, we may eventually reach a tipping point at which time enough areas will be at comparable pay levels that that level will become a de facto standard pay. This, combined with the nationalizing of retail stores, restaurants, service companies, and the like, lead to the belief that there will be an eventual flattening of geographic pay differences.