Perception is Reality: The Importance of Pay Fairness to Employees and Organizations

Fairness is in the eye of the beholder, and pay fairness is no different. The perceived fairness of an employee’s compensation is based on objective components (e.g., the extent to which pay rate is logically tied to the external market) and subjective components (e.g., an employee’s emotional response to the implied value statement made by compensation). Regardless of whether an employee’s perception is rooted in objective or subjective measures, the perception of pay fairness is just as important as the reality of it.

Employees need to feel the hard work they put into their job matches what they get back from it — and pay is an important component of this evaluation. It is known that pay is important to employees. Wiley (2011) reported 25 percent of employees say fair compensation is the single most important thing they want from their organization. The importance of pay fairness to employees can also be observed by its relationship to a number of important work and life outcomes, including employee engagement, turnover intentions, work stress, psychological and physical health, and life satisfaction.

But fair pay is not important to just employees; paying employees fairly is also in a company’s best interest.
There is a significant body of research suggesting that organizations with a more engaged workforce outperform their peers on a number of organizational performance metrics (Salonova, Agut, and Piero 2005; Harter, Schmidt, and Hayes 2002). Organizations may also save money through reduced work stress, which leads to improved psychological and physical health, which means fewer absences and better focus (Spector, Dwyer, and Jex 1988; Spector and Jex 1991; Wright and Cropanzano 1998). Turnover intentions may also be reduced, and the hefty cost of replacing an employee may be avoided by paying employees fairly (Fitz-enz 1997).

Compensation practices, among other organizational factors, have an impact on employee- and organization-level outcomes. This article will discuss why fair pay is important. Then, it will present steps compensation specialists, HR practitioners and managers can take to ensure they are promoting perceptions of fair pay.

THE BENEFITS OF FAIR PAY

The authors’ research indicates that employees who believe they are fairly paid are more engaged, are less likely to quit, experience less stress at work, feel healthier physically and psychologically, and are more satisfied with their personal life. (See Figure 1.)

An organization’s total rewards architecture and its culture can have an impact on the way employees perceive the fairness of their pay. Compensation programs anchored firmly to the external market are immediately credible from a fairness perspective, and organizational transparency can increase an employee’s faith in the fairness of all corporate programs, including compensation. In addition, external forces, such as an employee’s friends, family and coworkers, can influence perceptions of fair pay. The increasing availability of salary data over the Internet provides yet another point of triangulation as an employee considers the fairness of his/her pay.
Given the many forces that influence perceptions of fair pay, it is not surprising that a gap may exist between the objective fairness (or competitiveness) of an employee’s pay and his/her perception of whether the pay is fair. If organizational leaders and compensation teams can help reduce the gap between employees’ perceptions of fairness and the reality that pay has been calculated using a fair, consistent and rigorous methodology, they may have a positive impact on employees’ lives at and outside of work, as well as help the organization’s bottom line.

**DRIVERS OF FAITH IN PAY FAIRNESS**

Figure 2 illustrates the three key drivers of an employee's faith in the fairness of his/her pay:
- Understanding how pay is determined
- Knowing how to maximize pay
- Believing pay is related to performance.

Furthermore, employees who rate favorably on these three drivers of belief in fair pay show significantly higher scores along every dimension of the Employee Engagement Index (EEI). (See Figure 3 on page 68.) Employee engagement is defined as “the extent to which employees are motivated to contribute to organizational success, and are willing to apply discretionary effort to accomplishing tasks important to the achievement of organizational goals.” In the EEI, employee engagement is measured by asking employees how closely they agree with the following four items:
- I am proud to tell people I work for my organization (Pride).
- Overall, I am extremely satisfied with my organization as a place to work (Satisfaction).
I would gladly refer a good friend or family member to my organization for employment (Advocacy).

I rarely think about looking for a new job with another organization (Commitment).

**CURRENT PERCEPTIONS OF PAY FAIRNESS**

The importance of understanding differences in engagement levels between those who believe they are paid fairly and those who do not becomes clear when current perceptions of pay fairness are examined.

Half of employees in the United States and 40 percent globally believe they are paid fairly. Seven out of 10 (70 percent) employees in the United States understand how their pay is determined; globally, three out of five employees understand how it is determined (61 percent). Fifty-seven percent of U.S. employees know how to maximize their compensation; globally, fewer than half of employees know what to do (48 percent). (See Figure 4.)

Understanding pay and how to maximize it increases with an employee’s level within the organization (see Figure 5), most likely because individuals at higher levels in the organization receive greater exposure to the mechanics and motivations behind compensation programs. Exposure through participation in the development, and potentially in the approval, of base and variable pay programs provides a level of visibility not available to rank-and-file employees. Even managers not involved in development and approval would no doubt be exposed to the programs via management training conducted by human resources during program roll-out.

![FIGURE 3 Kenexa’s Employee Engagement Index](image-url)
The bottom line is that many employees, and even many front-line and mid-level managers, do not understand how their pay is calculated or how to maximize it. Resolving this knowledge deficit and increasing employee belief in the fairness of pay represents a significant opportunity to increase engagement levels.
BUILDING FAITH IN PAY FAIRNESS
The data suggest an employee’s perception of pay fairness is largely a function of transparency. Although a startling number of employees do not perceive their pay to be fair, these perceptions are largely under compensation practitioners’ control through involvement in, and communication about, compensation practices. If an employee has visibility into a compensation program and understands its general design and how it can be influenced, he/she will likely perceive that program to be more fair. For this reason, even organizations with less lucrative pay packages can still leverage compensation as a tool to drive retention and engagement.

Driving the right level of visibility into pay programs and philosophies, while keeping in mind the organization’s overall culture around transparency, is no small task. Effective communication relies not only on the mechanics of communication, but also on the message itself. Compensation practitioners play a key role in driving this critical transparency.

Helping the Organization Understand How Pay Is Determined
Organizational leaders can take a number of steps to help their employees understand their pay. First, understand and accept that employees will seek out compensation data from external sources, such as the Internet, friends and colleagues, affinity group publications and government publications. Absent context or education, they will likely use this data to judge the fairness of their own pay. Recognize that an employee who has sought this data is making an effort to be a more informed participant in the employer-employee dialogue. That employee represents an opportunity to close the gap between the perception of pay fairness and the reality that there are many valid reasons why the organization’s compensation program does not match certain sources of external data.

Rather than taking a defensive position, try to understand the employee’s data, and help that worker understand how it compares to the data the organization uses in the context of setting pay. Take this opportunity to share the employer’s stated market position, the types of organizations the employer compares itself to in conducting the market assessment and the breadth of the labor market as evidenced by the geographies reviewed in the assessment.

Second, build a communication program around pay transparency. Providing managers and field HR staff with visibility into the organization’s compensation philosophy and policies will enable and empower them to have informed conversations with employees. Visibility may cover a wide spectrum, with some organizations revealing deep detail, such as market rates and salary ranges, while others reveal only general policies. The right level of transparency reflects the organization’s overall approach to information-sharing. Whether the culture is open or conservative, the information to be shared can still be communicated clearly, frequently and via multiple channels.
Finally, the pay discussion should not focus exclusively on base pay. Many organizations have introduced variable pay programs into the rewards mix, and need to ensure that employees understand not only the inherent value of variable pay programs, but also their influence on the market position and overall pay mix. Industry, organization size and level of maturity, organizational culture and external economic conditions can influence the mix of fixed and variable pay, cash and equity, benefits and work-life balance. When employees understand the genesis of this mix, they are better able to maximize their earning potential through these programs.

**Helping the Organization Understand How to Maximize Pay**

While base salary can be maximized to a modest extent via performance-based salary increases, most opportunities to maximize pay will involve variable compensation, including short- and long-term incentives. Ensure that managers and employees understand all variable pay/incentive programs, particularly the metrics that will determine the size and timing of any payout. Share examples of performance levels and the corresponding payout. If part of the organization's compensation package is in the form of stock, make sure your employees understand exactly how stock plans work. Do not assume that your employees understand stock programs.

**Helping the Organization Understand the Relationship of Pay to Performance**

Even seemingly simple salary increase programs can be easily misinterpreted by managers and employees. For example, “pay for performance” is often confused with “increase for performance.” Pay for performance dictates that where an employee is paid in a salary range should coincide with performance over an extended period of time. Employees with higher levels of performance will be paid higher in the range and lower levels of performance will be paid lower in their range. This is in contrast to the increase for performance concept that suggests employees of equal performance would get equal increases with no regard to their position in range. Pay for performance is concerned with the employee's salary movement over time, while increase for performance is concerned only with the size of the current year increase.

Nuances like this can be easily misinterpreted by managers and employees; mitigate this possibility by providing adequate training, tools and guidelines for managers. Provide managers with performance-based guidelines for merit budget distribution and encourage managers to share that information with employees. If a matrix is used, share it.

**PAY TRANSPARENCY AND COMMUNICATION CULTURE**

Pay transparency partially mediates the relationship between communicative organizational culture and pay fairness*. In other words, people who work in
Communicative organizations are more likely to understand their organization's pay practices, and are therefore more likely to believe they are paid fairly. (See Figure 6.) Also, employees who understand their pay better feel more encouraged to participate in decision-making that involves them. (See Figure 7.) It may be that good communication around pay practices from leaders also encourages employees to communicate upward as well. This does not mean that compensation
leaders at organizations who score high on communication can be less vigilant, but underscores their need to maintain that high level of transparency in the development and delivery of pay programs. Those organizations with a culture that is less transparent should consider increasing transparency.

**PERCEPTION IS REALITY**

Compensation practices can be intellectually complex and emotionally charged. Employee attitudes and feelings about their pay and its fairness are just as important as reality. Focusing on pay transparency helps ensure that employees understand the care and rigor deployed in the development of their compensation packages.

It should be noted that while this article is focused on pay, the term “pay” is broadly defined to include all aspects of the total rewards architecture. The discussions with employees should also incorporate, when appropriate, benefits and nonfinancial aspects of the rewards architecture, with the same care taken to ensure transparency and understanding. In today’s economy, fringe benefits are anything but fringe from a cost perspective, representing a 30 percent – 40 percent premium in addition to an employee’s salary. These benefits are provided to be compliant from a regulatory perspective, but they can also be leveraged to create more attractive rewards packages, and hence have a place in driving perceptions of fairness.

If perception is reality, the challenge is to foster an environment in which employees perceive that they are paid fairly. Embracing pay transparency allows compensation practitioners to leverage the hard work done in developing competitive and equitable pay programs to garner good will and trust from managers and employees across the organization. Helping employees understand how their pay is determined, how they can maximize their pay and how their pay is tied to their performance are major steps forward, and can help practitioners and leaders fully use compensation as a driver of organizational success, not just a cost.

*To see the results of the SEM, contact author Rena Rasch.*

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Rasch strives to provide empirically-based solutions to HR practitioners’ biggest questions. Topics of interest include employee engagement, generational differences in the workplace, trust in leadership, work-life balance and work stress, unionization intent, why employees join and leave their organizations and compensation practices. She has a Ph.D. in industrial and organizational psychology from the University of Minnesota.

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REFERENCES


