Perception is reality

The importance of pay fairness to employees and organizations

Contents:

The WorkTrends™ survey

Employee responses presented in this report were gathered as part of IBM's WorkTrends™ survey,[1] which has been administered annually or biannually since 1984. In 2012, the WorkTrends survey was taken online by approximately 33,000 employees in 28 different countries who work full-time for an organization of 100 staff members or more.[2] The survey asks employees more than 200 questions about employee opinions and attitudes, manager and leadership behaviors, organizational practices, and demographic variables. WorkTrends data are unique because they are a representative sample – a cross-section of workers across the globe, which enables us to generalize our conclusions to the broader working population.

Executive summary

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 both objective components such as, the extent to which pay rate is logically tied to the external market, and subjective components such as an employee's emotional response to the implied value statement made by compensation. Independent 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 that the hard work they put into their job matches what they get back from it – and pay is an important component of this evaluation. Dr. Jack Wiley reported in his book *RESPECT: Delivering Results by Giving Employees What they Really Want*, that 25 percent of employees say fair compensation is the single most important thing they want from their organization.[3] 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.

However, fair pay is not just important to employees; it can be 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.[4, 5] Organizations may also save money through reduced work stress, which can lead to improved psychological and physical health, meaning fewer absences and better focus.[6, 7, 8] Turnover intentions may also be reduced and the hefty cost of replacing an employee[9] may be avoided by paying employees fairly.

Compensation practices, among other organizational factors, impact both employee- and organization-level outcomes. In this report, we will discuss why fair pay is so important. Then, we will present steps compensation specialists, Human Resources (HR) practitioners and managers can take to help ensure they are promoting perceptions of fair pay.

The benefits of fair pay

Our research indicates that employees who believe they are fairly paid are more engaged, 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*).

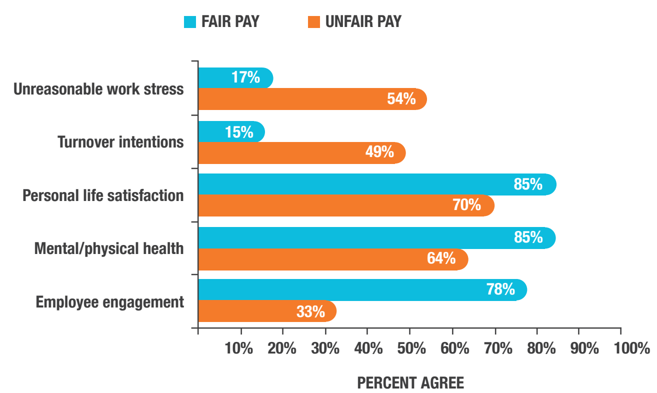

Figure 1: Impact of perceptions of pay fairness

Both an organization's total rewards architecture and its culture can impact the way employees perceive the "fairness" of their pay. Compensation programs anchored firmly to the external market are readily credible from a fairness perspective, and organizational transparency can increase an employee's faith in the fairness of corporate programs, including compensation. In addition, external forces like an employee's friends, family and co-workers 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 or 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 or 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 be able to positively impact employees' lives both at and outside of work – and help their bottom line.

Drivers of faith in pay fairness

Our research shows there are three key drivers of an employee's faith in the fairness of his or her pay (see *Figure 2*):[10]

- Understanding how pay is determined
- Knowing how to maximize pay
- Believing pay is related to performance

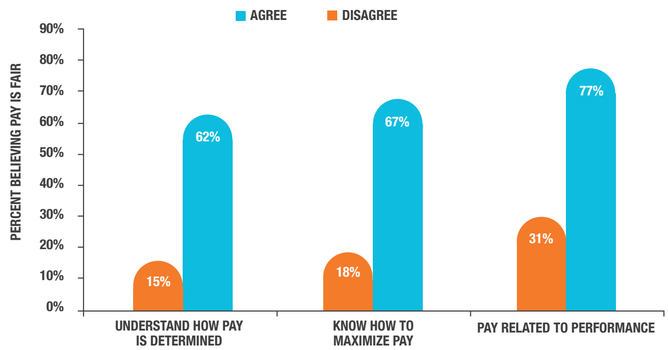

Figure 2: Faith in pay fairness

Furthermore, employees who rate favorably on these three drivers of belief in fair pay show significantly higher scores along every dimension of IBM's Employee Engagement Index (EEI; see *Figure 3*). 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."*

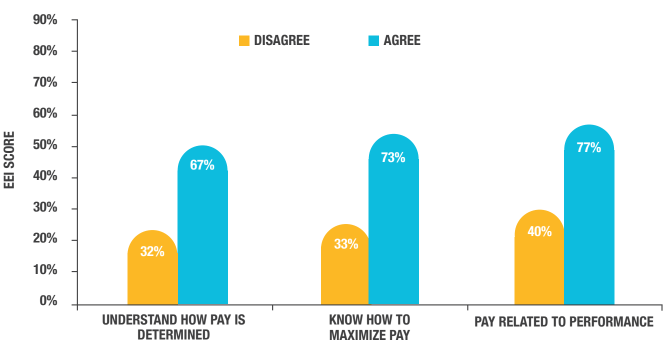

Figure 3: Employee engagement index

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 we examine current perceptions of pay fairness.

Only half of employees in the US, and 40 percent globally, believe they are paid fairly. Seven out of 10 (70 percent) employees in the US understand how their pay is determined. Globally, three out of five employees understand how it is determined (61 percent). Only 57 percent of employees in the US know how to maximize their compensation. Globally, less than half of employees know what to do (see *Figure 4*).

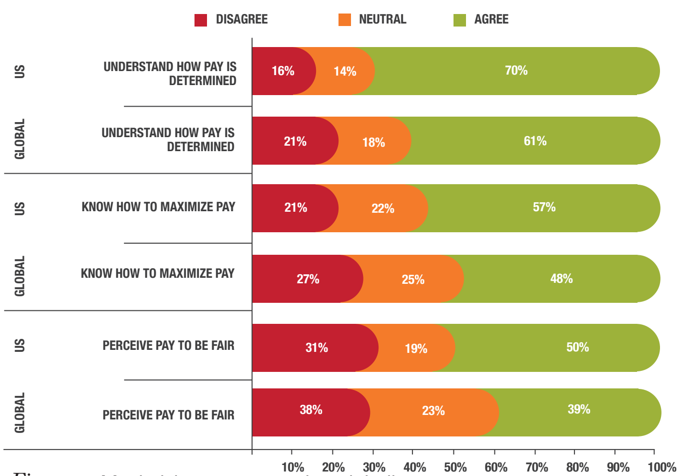

Figure 4: Maximizing compensation globally

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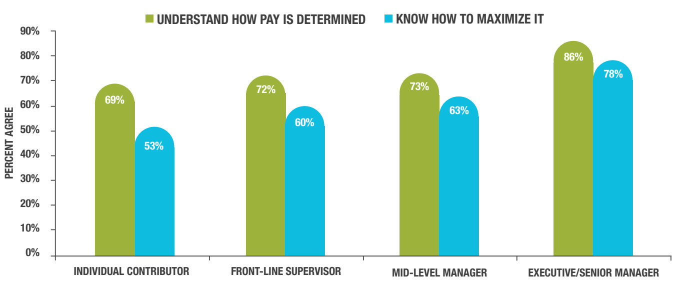
Understanding pay and how to maximize it increases with an employee's level in the organization (see *Figure 5*), most likely because individuals at higher levels in the organization receive greater exposure to the mechanics and motivations behind compensation programs. Exposure through participation 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 HR during program roll out.



Note: WorkTrends 2012 U.S. sample.

Figure 5: Understanding pay in each level of the organization

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 potentially significant opportunity to increase engagement levels.

Building faith in pay fairness

The data above 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 can largely be controlled through involvement in and communication about compensation practices. If an employee has visibility into a compensation program, understands its general design and how it can be influenced, he or 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 do a number of different things 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, and 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 their data and help them understand how it compares to the data the organization uses in the context of setting pay. Take this opportunity to share your stated market position, the types of organizations you compare yourself to in conducting your market assessment, and the breadth of your labor market as evidenced by the geographies you review in your assessment.

Second, build a communication program around pay transparency. Providing managers and field HR with visibility into the organization's compensation philosophy and policies can help 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 organization's 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 help 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 all 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 tend to be better situated 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, the majority of opportunities to maximize pay will involve variable compensation, including short- and long-term incentives. Help ensure that managers and employees understand virtually all variable pay/incentive programs, particularly the metrics that will determine the size and timing of payouts. Share examples of performance levels and the corresponding payout. If part of your 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.

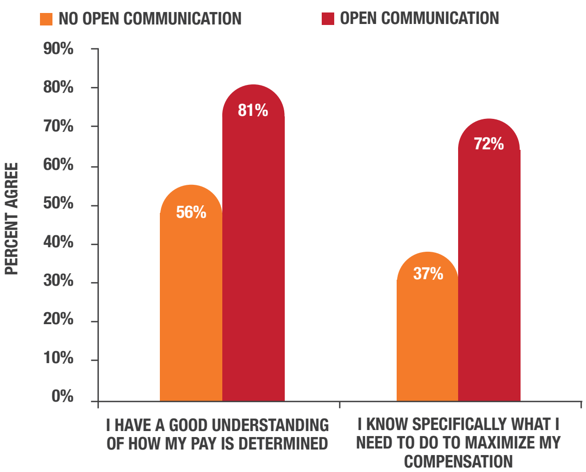
Helping the organization understand the relationship of pay to performance

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 would suggest that employees of equal performance would get equal increases with no regard to their position in the range. Pay for performance is concerned with the employee's salary movement over time, while increase for performance is primarily concerned with the size of the current year increase.

Nuances like this can be easily misinterpreted by manager and employees, but you can 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 you utilize a matrix for increase determination, share it.

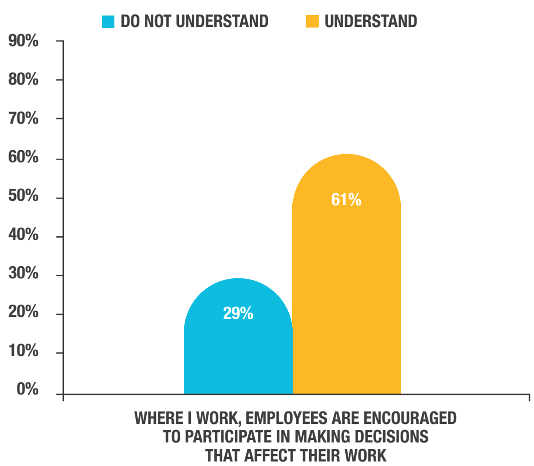
Pay transparency and communication culture

Pay transparency partially mediates the relationship between communicative organizational culture and pay fairness.[11] In other words, people who work in communicative organizations are more likely to understand their organization's pay practices (see *Figure 6*), and are more likely to believe they are paid fairly. Also, employees who better 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 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. Organizations with a culture that is less transparent should consider increasing transparency.



Note: WorkTrends 2012 U.S. sample.

Figure 6: In my organization, there is open, honest, two-way communication



Note: WorkTrends 2012 U.S. sample.

Figure 7: I have a good understanding of how my pay is determined

Perception is reality

Compensation practices can be both 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.

We should also note that while this report is focused on pay, we define the term “pay” broadly to include each aspect of the total rewards architecture. The discussions we have with employees should also incorporate, when appropriate, benefits and non-financial aspects of the rewards architecture, with the same care taken to help ensure transparency and understanding. In today’s economy, fringe benefits are anything but “fringe” from a cost perspective, representing a 30 to 40 percent premium in addition to an employee’s salary. We provide these benefits in order 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, our challenge is to foster an environment where our employees perceive that they are, in fact, paid fairly. Embracing pay transparency enables us to leverage the hard work we have done to develop competitive and equitable pay programs that 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 utilize compensation as a driver of organizational success, not just a cost.

Focusing on pay transparency helps ensure that employees understand the care and rigor deployed in the development of their compensation packages

For more information

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1 Kenexa WorkTrends Survey. 2012. In its current form, WorkTrends is a multi-topic survey completed online by a sample of employees representative of a country's working population in terms of industry mix, job type, gender, age and other key organizational and demographic variables. In most countries, survey takers must be adults who work full-time for an organization of 100 employees or more; this threshold drops to 25 employees or more in countries with smaller economies or hard-to-reach populations. The survey has over 200 items that cover a wide range of workplace issues, including senior leader and direct manager effectiveness, recognition, growth and development, employee engagement, customer orientation, quality emphasis, innovation, corporate social responsibility, workplace safety, work stress and performance confidence. In 2012, over 33,000 employees were surveyed, representing 28 countries.

2 Except for UAE, KSA and Ireland, which required only 25 staff members.

3 Wiley, J & Kowske, B.; RESPECT: Delivering Results by Giving Employees What they Really Want, October 2011, Pfeiffer

4 Salanova, M., Agut, S., & Peiró, J. M. (2005). Linking Organizational Resources and Work Engagement to Employee Performance and Customer Loyalty: The Mediation of Service Climate. Journal of Applied Psychology, 90, 1217-1227. http://psycnet.apa.org/psycinfo/2005-14549-013

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6 Spector, P. E., Dwyer, D. J., & Jex, S. M. (1988). Relation of Job Stressors to Affective, Health, and Performance Outcomes: A comparison of multiple data sources. Journal of Applied Psychology, 73, 11-19. http://psycnet.apa.org/journals/apl/73/1/11/

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10 $R^2 = .38$

11 To see results of the mediation analysis, please contact Rena Rasch at rrasch@us.ibm.com.

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