a Fairness approach to Market-Based Pay

By Kimberly Merriman, Ph.D.

Market-based pay systems — systems that focus on external instead of internal equity and operate without traditional pay grades and ranges — are meant to appeal to employees and provide hiring and retention advantages. However, companies often sabotage the success of market-based pay with inadvertent violations of employee fairness expectations.

Expectations of pay fairness take four distinct forms, including procedural, individual, external and internal. External equity, or how pay rates compare to the market, and internal equity, or how pay rates compare across different jobs within the organization, are the most well-known. Procedural fairness relates to how pay decisions are made, rather than the pay amount itself, while individual fairness is concerned with pay differences between individuals doing the same job within the organization.

Meeting employees' external equity expectations does not alone ensure pay satisfaction. A study published in the November/December 2003 *Compensation and Benefits Review* by researchers David Terpstra, Ph.D., and Andre Honoree, Ph.D., which surveyed employees across a number of colleges and universities, shows that all four areas of fairness are important to pay satisfaction. And based on survey feedback, procedural fairness is significantly more important than the others.

In order for a market-based pay system to fully succeed, companies must go beyond emphasizing external equity and work to maintain a well-rounded sense of fairness. The good news is this is achievable without significant extra compensation expense through administration and communication of the pay plan. Following are the key ways in which to improve employee perceptions of fairness within a market-based pay plan.

More Fair Procedures

In addition to being possibly the most important fairness factor in encouraging pay satisfaction, studies show that individuals find even negative outcomes more acceptable if they perceive the process used to determine the outcome is fair. Under a market-based system, without the clear structure of grades, ranges and formal job evaluation, pay procedures can appear vague and arbitrary. Procedural fairness perceptions with market pay hinge on the pay survey and its application.

Pay Survey Acceptance

Of course a fair system must start with good pay data that employees accept. Many pay surveys already are outdated by the time they're published and employees — turned armchair experts thanks to an abundance of Internet pay surveys and frequent job searches — know it. Demanding better third-party market data is a must. Clark Consulting recently met this challenge for IBM, now providing quarterly pay survey results from 143 companies with a quick 30-day turnaround.

The pay survey stage also is a good point to allow employee "voice." The voice effect is well-established in academic research. Individuals find a process to be fair if they have an opportunity for input. Interestingly, this effect holds even when the input is not instrumental in determining the process. Most of the time, people just want to be heard. An easy way to incorporate voice in the pay survey is to simply ask existing employees which types of companies they feel are relevant to the survey. In other words, where would they look for another job?

Appropriate Market Matches

HR professionals sometimes equate intricacy with accuracy and become so enamored with mathematical preciseness that they lose sight of their primary objective — employee acceptance. An easily explained and understood method of matching jobs to the market is actually more likely to generate feelings of fairness from employees. For instance, basic slotting or weighting of different market rates for jobs that have no direct market match is appropriate.

Beyond the initial market match, it is critical to procedural fairness perceptions to frequently re-examine the matches and identify any differences, even small, between internal and market jobs as they evolve. Continuous recognition and consideration of differences between internal and market jobs is more important to employee fairness evaluations than the actual amount of the pay adjustment. A difference in views on pay adjustments is simply a judgment issue, while completely overlooking a contribution of the job is a violation of the employee's psychological contract.

QUICK LOOK

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Communicate Market Information Carefully

Market rates can be interpreted in different ways, creating a potential point of contention for employees. A company may define the market by industry, whereas employees may consider jobs by profession, including higher-paying industries in their informal sample. Companies normally use a percentile measure of market rates, which excludes the influence of outliers. Employee focus gravitates to the high extremes of market rates, with selective memory of the rates that are most attractive.

To minimize this problem, a large Midwest corporation that recently converted to a market-based system carefully communicates market data to employees. Its message to employees is: "We looked at market data and here's the value we placed on your role," which suggests a more interpretive process than a direct match to one source. It's more important employees understand that broad market factors were considered than to try and convince them one piece of market information is more accurate than another.

Individual Fairness

Individual fairness issues stem from employee comparisons of their own performance and pay to that of their co-workers doing the same job. Years of empirical studies building on Adams' Equity Theory, a classic academic theory that sheds light on how employees evaluate pay, indicate individual fairness calculations are not based on a simple and direct comparison of pay rates, but rather a more involved comparison of performance-to-pay ratios. Employee fairness expectations are violated if pay fails to vary appropriately across performance differences.

Market-based pay systems allow greater latitude to distinguish individual performance differences as compared to traditional grade and range systems, which are constrained by pay floors, ceilings and comparatios. Even with this latitude, however, inappropriate use of performance appraisals and pay budgets often limit pay variations.

Focus on Relative Differences

In terms of pay-fairness perceptions, it's the performance appraisal's ability to uncover relative differences in performance that matters most. An appraisal system may be unduly harsh or overly generous as long as it is consistently applied across individuals in the same job so relative performance differences are identified.

The relative performance and respective pay differences influence individual fairness perceptions more than the absolute pay amount. This theory can be informally tested by simply asking a group of top employees how they'd feel if they were paid at the 90th percentile of market rates. Then mention that lower performers will be paid the same amount and see the response immediately changes.

Pay Differentials on a Budget

The easiest way to pay employees for performance differences is to increase rewards for top performers. Managers sometimes fail to recognize that pay differentials and employee fairness expectations also can be met by keeping low performers below the 50th percentile of market rates. Another budget-sensitive approach is to keep all employees at the same percentile and recognize individual differences in performance through a variable pay component.

Internal Fairness

Even though internal equity — pay relationships across different jobs in the same organization — may be the least-significant fairness factor of the four, it still has some importance. Market-based systems can de-emphasize internal equity, but not ignore it altogether. Employees expect equal treatment.

Equal treatment under a market-based system is expressed through consistent external competitiveness polices with regard to matching, lagging or leading the market. For instance, paying engineers at the 75th percentile and HR staff members at the 50th percentile can generate employee resentment. If the policy unduly impacts women or other protected classes, this opens the organization to allegations of discrimination. All pay differences across jobs should be a result of objective market-rate differences, rather than policy differences, in order to be seen as most fair.

Call to Action

Meeting employee-fairness expectations within a market-based pay plan does not require a large cost, but does provide a large return. Pay fairness affects pay satisfaction, retention and employee motivation. Often companies look to improve a pay plan by infusing it with more money. While employees will always welcome more money, it's important to remember that feelings of pay fairness cannot be bought. WS

ABOUT THE AUTHOR:

Kimberly K. Merriman, Ph.D., is a business writer and educator specializing in employee issues and a WorldatWork member since 2004. She can be reached through her Web site at www.kkmerriman.com or 215/237-6686.

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