

*When setting pay rates, compensation managers must take into consideration the employees' perception of fair, equitable compensation.*

## *Pay Equity: Internal and External Considerations*

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**E**quity (or fairness), a central theme in compensation theory and practice, arises in many different contexts. Here, for example, are some major areas:

- The legal and economic issue of equal pay for similar work (comparable worth).
- Pay differences caused by external competition or market pressures.
- The fairness of individual wage rates for people who are doing the same job.
- Individual employee views of their value relative to their pay.

A company's approach to equity is as important as the actual pay programs it implements. Companies typically emphasize external equity in the design of their compensation structures. This focus on external equity enables a company to develop compensation structures and programs that are competitive with other companies in appropriate labor markets. Perceptions of equity can also influence a company's ability to attract, retain, and motivate its employees.

Employee perceptions of equity and inequity are equally important and should be carefully considered when a company sets compensation objectives. Employees who perceive equitable pay treatment may be more motivated to perform better or to support a company's goals. Individual employees, however, perceive equity in many different ways. Therefore, it is difficult to specify one definition of equity that is applicable to all situations.

In sum, compensation equity poses a conceptual and practical challenge: how to reconcile the company's ability to pay (financial resources), desire to pay (image), and

need to pay (labor market) with the employees' perception of equity (fairness).

*Definitions of Equity*

Equity is commonly defined as anything of value earned through providing or investing something of value. Fairness is achieved when the return on equity is equivalent to the investment made. As it relates to compensation, fairness is achieved when pay equates to the value of the work performed. Inequity, on the other hand, occurs when the value of the work performed does not match the value of the compensation received.

*Equity Theory*

Early studies indicate that inequitable treatment directly affects and influences employee behavior and performance. In *Equity Theory Towards a General Theory of Social Interaction* (The Academic Press, 1976), J. Stacy Adams proposed that an employee continuously monitors his or her inputs and outputs on the job, and perceives an equitable situation when the ratio of his or her inputs and outputs are equal to those of other employees. If this ratio is not equal, the employee may feel angry (as a result of not being paid enough) or guilty (as a result of being paid too much). Either feeling could result in dissatisfaction or discomfort.

One can view equity from either an internal or an external perspective. Internally, equity can be expressed in terms of employees who do the following:

- Perform similar jobs.

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- Perform dissimilar jobs.
- Work within the same department.
- Work in different departments.

Externally, equity can be expressed in terms of employees who have these relationships to one another:

- In the same industry.
- In different industries.
- In the same union.
- In the same profession.
- In the same geographic location.
- In different geographic locations.
- In organizations of similar size.
- In organizations of differing sizes.

Specifically, equity can be grouped into four major categories: external equity, internal equity, individual equity, and personal equity. Each is discussed below.

#### *External Equity*

External equity exists when an employer pays a wage rate commensurate with the wages prevailing in external labor markets. Assessing external equity requires measuring these labor markets. There is, however, no single labor market for a particular job. Supply and demand differ substantially among markets, resulting in significant variation in wages across labor markets.

The following factors contribute to these wage differences among markets:

- Geographic location.
- Industry sector.
- Union status.
- Organization size.
- Product competition.
- Company prestige.
- Education and experience level of available work force.
- Licensing or certification requirements called for by the job.

Some combination of these factors determine the labor market for a particular job. Employers should carefully define the appropriate market(s) to assure accurate external wage comparisons. Defining the market too narrowly can result in wages that are higher than necessary. If, for example, a company doing business in two locations defines its pay practice solely in terms of a metropolitan labor market, it could set wages that are unnecessarily high for its rural areas. Conversely, defining the market too broadly may cause an organization to set wages too low to attract and retain competent employees.

### *Internal Equity*

Internal equity exists when an employer pays wages commensurate with the relative internal value of each job. This is established according to the employer's perception of the importance of the work performed.

Before an organization can estimate the importance of each job, however, it must first determine the job-related factors that will be used for setting compensation levels—in short, compensable factors. Here are some typical compensable factors used for lower-level jobs:

- Education required.
- Experience required.
- Physical demands.
- Responsibility for equipment/materials.
- Responsibility for the safety of others.
- Supervisory/managerial responsibility.
- Working conditions.
- Accident or health hazards.
- Public contact.
- Manual dexterity.

Determining the relative internal value of jobs in a large or complex organization can be a difficult process. Job-evaluation methods are often used to develop a job hierarchy that reflects the relative value of jobs on the basis of skill, effort, responsibility, and working conditions. A number of job-evaluation approaches have been developed. Such approaches include (1) whole job ranking, (2) classification, (3) point factors, (4) factor comparison, (5) slotting, and (6) scored questionnaires.

Whether an organization chooses a rigorous and disciplined approach to job evaluation or a relatively simple one, it should be noted that all approaches are subjective. They depend on management judgement for their accuracy and management commitment for their applications.

### *Individual Equity*

Individual equity exists when an employer compensates individuals who are in similar jobs on the basis of variations in individual performance—so-called pay for performance. Excellent performers, for example, would receive more compensation than average performers. For reasons that will be explored in greater detail later, the most important compensation decisions are those that differentiate between the pay received by individuals within the company who are performing the same job.

### *Personal Equity*

Personal equity, unlike external, internal, or individual equity, involves no direct comparison of one individual's compensation with another's. Personal equity exists

when an employer pays a wage rate that satisfies an employee's own perception of his or her worth. The standards applied by each person relate to that particular individual's previous experiences and his or her knowledge of the market value of similar jobs. These internal standards can determine the employee's pay satisfaction or dissatisfaction.

*How Companies  
View Equity*

Companies make several basic decisions concerning their approach to equity when formulating compensation objectives. For example, they decide the amount of compensation an employee will receive compared with that of employees working in other companies, the amount of compensation that employees will receive compared with that of individuals who have different jobs within the same company, and the differences in compensation that will exist because of individual job performance. Companies approach these issues through their fundamental approach to equity strategy.

In developing a compensation program, organizations generally compare their own employees' compensation with the compensation of those who work for other firms (that is, external equity). There are three basic reasons that organizations emphasize external equity:

1. The belief that failure to match other companies' salaries will lead to a decline in employee morale and productivity.
2. The belief that below-average wages will hinder a company's ability to attract good people.
3. The opinion that management is morally obligated to pay prevailing wages, and that an inability to do so is an admission of managerial failure.

When comparing their compensation structures with those of external labor markets, companies focus on these key variables.

- *Competitive market.* Companies doing business in highly competitive industries are often forced to balance the need to control costs with the need to pay higher wages to attract a talented workforce.
- *Industry sector.* Wages in labor-intensive industries (for example, telecommunications), constitute a significant portion of overall operating costs. Therefore, there is constant pressure to control wages. In nonlabor-intensive industries (for example, transportation) however, where wages do not represent a major portion of operating costs, there is less pressure to reduce wages to control cost.
- *Organization size.* Large organizations tend to pay more, sometimes significantly more than small organizations.
- *Union status.* Labor unions that establish themselves in an industry able to meet their demands can have a considerable impact on raising industry wage levels.
- *Image.* Sometimes organizations pay more than the "going rate" to establish themselves as a good place to work. These organizations believe that having a reputa-

tion as a high-paying company can aid recruitment. In addition, organizations interested in being an industry pay leader may offer higher wages simply to demonstrate their leadership position.

- *Geographic location.* Companies doing business in certain geographic locations frequently compensate their employees on the basis of the area's prevailing economic conditions. Such conditions may be a result of the local cost of living or the need to attract and retain employees in less desirable areas.

Companies traditionally emphasize the external equity of their compensation structures. For example, a 1975 Bureau of National Affairs study showed that over 80% of both large and small firms ranked external competitiveness as their most important compensation objective. This emphasis on external equity demands the availability of high quality of labor market data. Because labor markets tend to be highly variable, difficult to track, and difficult to describe, companies are often forced to participate in elaborate, costly wage surveys to get the data they need.

Companies are beginning to recognize some of the limitations associated with focusing on external equity as the primary basis for setting compensation objectives. A 1985 study by the Conference Board showed that employers are starting to consider internal factors as more important than external factors in setting wage levels. These companies recognize that overemphasizing external equity may detract from important internal equity considerations.

*How Employees  
View Equity*

Individual employees view equity differently from the way organizations view it. While organizations tend to compare themselves with other organizations, individuals tend to compare their pay with that of other people within the organization. For this reason perceptions of internal equity can influence a company's compensation objectives as much as or more than external equity can.

A study conducted in 1972 by Allan N. Nash adds insight to this issue. Participants were asked which of the following situations would make them the most angry:

1. If they were paid less for similar work than employees were paid in *other* organizations.

2. If they were paid less for the same work than employees were paid in their *own* organization.

3. If they were paid less for different work than employees were paid in their *own* organization.

Seventy-eight percent of the respondents indicated that they would be the most angered if they found themselves paid less than others doing the same job in their *own* organization (#2). (Of this 78%, 64% ranked similar job/different company second in importance [#1].)

In addition to pay, there are many things that influence an employee's perception of equity. Studies show that workers often rank job security, working conditions, advancement opportunities, management appreciation, relations with co-workers, and flexibility of hours or job assignment ahead of pay. But because job security is linked to stability of income, it is possible that pay is more important than these studies indicate. The fact remains, however, that an individual's perception of equity is strongly affected by factors other than pay.

A question remains concerning how large a differential an employee must perceive between his or her own pay and that of employees in other applicable jobs before feelings of inequity result. Studies suggest that employees perceive pay inequity when there's a pay differential approaching 15%–20%. If this 15%–20% threshold is reached, what actions are employees most likely to take?

In such circumstances, employees are likely to take one of the following actions: Ask for a raise, reduce effort on the job, seek to reduce the pay of others (that is, complain), or leave the company. Of these four actions, leaving the company is probably the least likely because it carries with it the greatest risk. First, for specialized jobs in large organizations, an employee's skills may not be transferable to other organizations. Second, there are the unknown aspects of working conditions, quality of supervision, and co-workers associated with changing jobs. Finally, there are certain geographic constraints; even if an employee gets a suitable offer that meets all other criteria, it will be unacceptable if it is too far away. But even if employees don't quit, the negative consequences of retaining dissatisfied employees who feel that they are being treated unfairly can have significant motivational and cost implications for a company.

In summary, it appears that employees may look at compensation equity from a different viewpoint than that of their employers. Companies go to great lengths to establish mechanisms for assessing pay practices in other companies, while employees are primarily concerned with equity in their company.

*The Experts'  
Opinion*

Because external and internal equity operate independently, the wage suggested by the external labor market can differ dramatically from the wage dictated by an internal job ranking.

Historically, there has been considerable debate on which approach takes precedence. The following statements indicate the opinions of some compensation experts. The first two support emphasizing external equity, while the last two favor internal equity considerations.

- "In most cases, it makes sense to focus on external pay comparisons as the major criteria for determining total compensation levels. Both internal and external inequity have serious consequences for the organization. However, the consequences of exter-

nal inequity . . . are the most severe for the organization and are the ones that deserve primary attention." (Edward E. Lawler, *Pay and Organizational Development*, Addison-Wesley, 1981)

- "We feel it is important to underline the sovereignty of external equity influence on wages over internal equity influence. Certainly the power of a wage or salary to attract employees is based solely on external equity considerations. The retention power of a wage or salary is also influenced heavily by external equity considerations. When external and internal equity considerations are in conflict, we suspect . . . that external equity takes precedence." (Mark J. Wallace and Charles H. Fay, *Compensation Theory and Practice*, Kent Publishing Company, 1983)

- "Most pay comparison research suggests that it is probably more important to have internal equity than external. Employees can seemingly obtain a better grasp of whether they think they are fairly paid by a particular employer through looking at other jobs in that organization than they can by weighing external information." (Thomas H. Patten, *Pay: Employee Compensation and Incentive Plans*, The Free Press, 1977)

- "Experience seems to indicate that establishment of compromise rates in cases of conflict is probably the solution. Internal consistency is more important than strict external competitiveness." (Milton L. Rock, *Handbook of Wage and Salary Administration*, McGraw-Hill, 1984)

Finally, the American Compensation Association (ACA) and the American Society for Personnel Administration (ASPA) have recently issued a joint policy statement that reflects the current dilemma over external equity and internal equity.

Regardless of the methodology selected (in job evaluation), pay grades and pay ranges are ultimately determined by:

1. Market rates for comparable jobs – external competitiveness. This approach is referred to as the "labor market," or "market supply" approach.
2. Management's judgements as to the relative internal worth of the job's content – internal equity. Organizations may place different emphasis on either external competitiveness, internal equity, or a blend of the two depending on their objectives or circumstances.

The issue, therefore, is still how to reconcile the conflict between external and internal equity.

*Balancing External and Internal Equity* The quotations above suggest that there is no right or wrong answer to the question of which should be the primary consideration – external or internal equity – for formulating compensation objectives. However, companies must try to reconcile external and internal equity issues when setting wage and salary policy. The long-term need is to establish both a strategic organization-wide wage-level policy that specifically ad-

dresses a company's approach to pay relative to the marketplace (i.e., external equity), and an internal job evaluation methodology for use in assessing the relative value of each job in an organization (i.e., internal equity).

The strategic wage-level policy should take into consideration not only the characteristics of the external labor market, but also the jobs and job families that are most critical to the long-term success of the organization. This will help the organization meet its external equity objectives.

The internal job evaluation methodology positions the organization to address its internal equity objectives. Once the relative internal value and importance of different jobs is established, each job can be compared with appropriate labor markets. If discrepancies arise between individual jobs, they can be reconciled using the internal ranking system. Because employee perceptions of equity are most affected by comparisons with jobs that are similar to theirs, the internal ranking provides the best guidance for setting individual wage levels.

Occasionally, because of a short-term supply-and-demand imbalance, certain jobs may have to be paid more to attract and retain competent employees. These situations usually do not arise until the market for the job (or the job family) exceeds the company's wage by 15%–20%. When this occurs, it may be appropriate for a company to institute a pay policy exception for the affected job or group. However, the imbalance should be regularly checked and verified as, over time, it may no longer require special consideration.

Companies operating in several geographic locations often create separate pay policies for each location to take advantage of wage differences in local labor markets. Paying geographic differentials may, however, erode employee perceptions of internal equity. But because employee perceptions of equity are usually based on similar jobs in similar location and because geographic pay differentials are often less than 15%, paying geographic differentials will probably have a minimum negative impact. As a result, the decision to institute a geographic pay policy should be based more on strategic and economic considerations than on internal equity considerations.

In conclusion, organizations should consider a two-pronged approach to setting wage levels. External data should be used to establish strategic guidelines for overall company pay policy. In addition, a sound job-evaluation methodology should be used to determine the relative internal value of the company's jobs. This job evaluation methodology lays the groundwork for establishing internal equity. This approach provides an objective basis for making critical compensation decisions and adds increased credibility to an organization's pay practice and better satisfies employees' equity concerns.

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