Why pay packages based on fair criteria matter

blogs.lse.ac.uk/businessreview/2016/08/10/why-pay-packages-based-on-fair-criteria-matter/

10/08/2016

Happiness has a large relational (or relative) component. The amount of utility an individual derives from, say, an annual salary of $V depends, in part, on how $V compares to the salary $X received by a referent other (for example, a co-worker [Bruce Kaufman, 1999]

Overview

Let us start with the premise that what workers say and feel actually matters. In other words, rather than confining ourselves to pure rationality, let us consider employee perceptions and subjective feelings of happiness. Such a view has been at the cornerstone of many academic disciplines, albeit not so much neo-classical economics, which tends to view an individual as a rational utility-maximising self. Without getting into a philosophical debate, therefore, we ask ourselves the question: is it (absolute) income that determines level of satisfaction with life, or is it income relative to some referent other's? The answer to this question has important implications for policy makers as well as business leaders in terms of pay transparency, employee engagement and employee satisfaction.

Description of paper and its results

Our paper explores this question by studying older adults (45+) in Canada, some of whom are retired, while some are still working. Focusing on relative and absolute income and the happiness of older workers is important for several reasons: (i) the ageing of the population that is occurring across most western industrialised countries; (ii) the associated increase in the number of persons working beyond the typical age of retirement, something that has reversed a half-century trend towards earlier retirement; and (iii) because focusing on older adults allows estimates of self-reported well-being that can be compared between retired and non-retired individuals in a similar age group.

This last point is key because it allows us to compare how it is that both absolute and relative income might matter; whether it is through the channel of social interactions in the labour market (e.g. if relative standing amongst close comparators affects happiness levels, measures of relative income should matter more to those engaged in work and should matter less to those who have retired), or whether inequality has a more general/society-wide effect as argued by proponents of the so-called ‘Spirit Level Channel’, for example, that societal level inequality spills over and affects all people regardless of who they are or what they are doing.

Results show that for the retired people, absolute income (i.e. actual income in dollars) matters more than relative income, while for the non-retired individuals, relative income completely wipes away the influence of absolute income on reported levels of life satisfaction. In other words, the levels of happiness reported by the non-retired depend on their income relative to the median income of people of the same gender, in the same age group, living in the same province of residence. The more income working adults make over the median of their referent group, the happier they are. Those who earn below the median level of their referent group are less satisfied with life.

This relationship is consistent even after considering happiness correlates such as satisfaction with health, religiosity, marital status, gender and independence of work. The same relationship is not observed for retirees, implying that social comparisons do not play a role at the wider level. The ‘Spirit Level Channel’ is not at play, implying that social comparisons take place when people are still in the ‘rat race’ between life and work.

It would appear that relative income matters more to those facing more ‘daily and tangible income and status comparisons’ based on work experience and inter (as well as intra) organisational pay comparisons that are easier to see (harder to avoid) when one is still in the labour force. Once the metric by which to judge whether your own income is ‘large’ or ‘small’ is diminished (i.e., no longer having a job or a workplace to attend), then the pressure from social comparison diminishes.

Further, working males and females see their levels of happiness affected differently contingent on their relative income. The levels of happiness of females are much less volatile than males, contingent on relative income. Males tend to be much unhappier when they make below the median income of their referent group, and tend to be much happier when they make above or well above the median income.

Implications for policy makers and business leaders

These findings have important implications for policy makers as well as business leaders. For policy makers who are trying to bridge the inequality gap, these findings show that there is a pressing need to do so, especially for the non-retired. Dissatisfaction with life may have implications in terms of productivity and health of individuals, both of which can turn into costs to society at large.

For business leaders, one thing to bear in mind at the very least: workers will invariably compare themselves with their peers, and while there is not much managers and business leaders can do about this, they should spend more time designing pay packages that are deemed just and (procedurally) fair by employees. In other words, spend time designing attractive compensation packages that are based on fair statistics and that are explained to each individual employee. Better compensation practices may improve satisfaction, engagement, and ultimately retention of the top employees.

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Notes:

- *This post is based on Relative income, absolute income and the life satisfaction of older adults: do retirees differ from the non-retired?, Industrial Relations Journal, Volume 45, Issue 4, July 2014 , Pages 281–299*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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