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Fairness: the ultimate reward goal

Duncan Brown

Even before the controversy over MPs' expenses broke, earlier this year five Anglican bishops attacked the last 10 years of government for being lacking moral direction and increasing the gap between rich and poor. So what, you might say – their market share is hardly increasing is it? And in its highly regarded forecast of The World in 2009, *The Economist* predicted that as the global recession deepens 'a more elitist shift will occur: companies will worry about the performance of those at the top of the pyramid, while everyone else will be managed like a commodity'.

Performance-related and market-driven pay have indeed dominated the reward agenda for the last thirty years, with even the papacy introducing performance-related pay for its administrative staff last year. The annual reward survey from the CIPD reports that this remains the priority agenda for HR and reward directors – with the modern holy trinity of business alignment, rewarding high performance and market competitiveness topping their wish-list, having long-since supplanted the traditional reward strategy, to recruit, retain and motivate. Internal equity and fairness is much further down the list, seen as an important goal by fewer than half, and most of those in the public sector.

Surveys, however, tend to look at past practice, not the future. And, looking even further back, history tells us that in challenging economic conditions, demands for fairness tend to come to the fore. Just ask Louis XVI, whose claims of immortality failed to save him from the revolutionary masses. Or indeed some of those senior banking executives who metaphorically at least fell on their swords in late 2008, or 'voluntarily' waived their 'earned' bonuses, in recognition of the government's £20 billion plus bail-out of the sector (funded of course by us commodities).

Labour MP George Mudie wondered at the Treasury select committee inquiry into the banking crisis in late 2008, 'for all that we need incentives, why does a cleaner get 9 per cent and the chief executive 150 per cent? If there were some morality in it, we would not operate in this way'. Philippa Foster-Back, director of the Institute of Business Ethics agrees, arguing that HR directors should be driving an ethical agenda into the boardroom, and recognising the demotivating impact of 'top managers taking excessive rewards in lean times, rather than sharing the pain'. 'What's the use of being rich when everyone else is poor' asked the heroine of the pantomime *The Thief of Baghdad* I took my kids to see last Christmas.

Maybe those bishops are unto or onto something after all. 'The public mood is shifting, the gap between rich and poor is too wide', observe Polly Toynbee and David Walker in their best-selling book, *Unjust Reward: Exposing greed and inequality in Britain today*. Their staged focus groups in which banking and other well-paid executives display a comical ignorance of the level of national minimum wage and unemployment benefits may themselves be a little unfair and ungracious; but the raft of statistics they exhibit to justify their conclusion is tough to refute.

The economists amongst us may regard this contemporary reaction against high pay as simple jealousy, a cyclical and Pavlovian blip occasioned by the sharp jump in unemployment and decline in living standards. I would argue that it is far more deep-rooted and that HR functions need to be highly cognisant of this wider change in sentiment. As *The Observer* somewhat dramatically summarised it in its end-of-year review of 2008, 'it was the year the neo-liberal orthodoxy that ran the world (and thinking on reward) for thirty years suffered a heart attack of epic proportions'.

The drivers of change:

1. 'For the love of money ….': bankers and their bonuses

This new fairness agenda has a number of drivers and dimensions. First and most obvious is the financial crisis and the role of banking incentives in bringing it about. Remember what Jesus did to the money-changers in the temple? Commentators seem to all agree with the Financial Services Authority chief executive Hector Sants who wrote in an inquisitorial letter to his banking peers last October, that 'there is widespread concern that inappropriate remuneration schemes have contributed to the current market crisis'. One recent survey of the HR executives involved in designing and administering some of those schemes presents a somewhat spineless response, along the lines of, 'we knew there were problems with the designs, but were afraid to act first in case we lost our best people to competitors'.

Whether Joe Public can distinguish between the absolutely high level of rewards, and the complex and flawed intricacy of the scheme designs generating them is open to question. But the end result is the same: many of us feel ripped off by banking executives who earned a lot of money through incentive schemes that were, as Hector Sants put it, 'inconsistent with sound risk management' and effective governance. We can feel sympathy with the thousands of financial services staff who have been and will be laid off as a result of the crisis. But this is in the aftermath of a finance sector bonus pool that paid out £9.8 billion in the first quarter of 2008.

Research by the Institute of Business Ethics (IBE) in 2008 revealed that the public viewed executive remuneration as their top ethical concern. Even a survey by *The Financial Times*, with its glossy 'How to Spend It' supplement, found that a majority of the public in Western Europe believed that corporate executives were paid too much and the gap between rich and poor was too wide (74 per cent of us agreed in the UK).

The politicians have not been slow to spot a vote-winning opportunity. Our three main political parties have been falling over themselves in trying to claim the genesis and ownership of a social 'fairness' agenda. According to Will Hutton the banking crisis has demonstrated the need for the government to develop 'policies that will assure us all that capitalism will be arranged more fairly in future'.

Prime Minister Gordon Brown regards Britain as a country with 'a commitment to fairness, fair play and civic duty'. He spoke at last year's Labour party conference of the need 'to bring an end to rewards for failure' and of the benefits of Calvinistic thrift. Having learnt from his opinion poll-decimating blunder of removing the 10 per cent starting rate for income tax, a higher 50 per cent tax rate for those earning over £150,000 is now planned for 2010. French economy minister Christine Lagarde was even more aggressive, attacking 'perverse pay structures (encouraging) greedy and blind behaviour', while Luxembourg's Jean Claude Junker blasted 'the social scourge of excessive pay'.

2. 'All is vanity': executive pay

Second is this wider sense that, domestically and internationally, executive pay remains out-of-control. Boardroom pay increases amongst FTSE companies did in fact fall back in 2008 to under 6 per cent, but this is still well-ahead of the national rate of increase in average earnings. The long-standing pattern of higher percentage increases for the highest paid therefore continues. Since 1990, FTSE 100 chief executives' pay has increased from 17 to 75 times that of the average employee.

In the US, President Barrack Obama capped the pay of his senior officials on his first day in power and is supporting legislation to give investors the so-called 'say on pay'. One of the first actions of the last Democratic party administration after Bill Clinton's election was to enact a $1 million cap on executives' earnings, and Obama is doing likewise on bankers' earnings.

International comparisons and the global market for executive talent have of course been one of the primary justifications for higher executive pay and widening differentials over the last 30 years. But even here there is a sense that the argument is wearing thin. According to Mckinsey, 'the movement of employees between countries is still surprisingly limited', while research at Wharton Business School reveals a 30 per cent narrowing of the gap between US CEO earnings and their UK counterparts over the last decade.

Investment into this country is increasingly likely to be from Far Eastern rather than North American sources, and it will be interesting to see if acquisitive companies such as Tata (now owners of 'British' brands Jaguar and Tetley) are as supportive of such massive pay differentials. Indian Prime Minister Singh, (who incidentally holds a first class honours degree in economics from Cambridge) recently criticised the lavish pay levels and 'Western lifestyles' of Bollywood executives and IT moguls, arguing that 'in a country with extreme poverty, industry needs to be moderate in the emolument levels it adopts'. India has an estimated 83,000 dollar millionaires, but 40 per cent of its population of 1.1 billion survive on less than $1 a day.

3. 'Do unto others ….': equal pay

Third, there is equal, or rather unequal, pay. The female-male earnings gap has more than halved since the Equal Pay Act came into force in 1975, to 17 per cent. Yet most of that decline occurred at the time of the legislation. The gentle decline since then has certainly flattened and possibly reversed, and the gender pay gap remains at over 40 per cent for part-time workers and in sectors such as financial services. Are you happy to accept that unless we take some action then your daughters will be paid almost a fifth less than your sons, simply because of their gender?

Recent Equality and Human Rights Commission (EHRC) research found that women at senior levels had lost ground in their relative earnings position over the prior year in half of the occupations studied. A few high profile equal pay cases in the City may grab the headlines. But it is a damning statistic that despite the cost and complexity, 40,000 women took their employer to a tribunal claiming equal pay last year, the likely tip of an iceberg of claims that are settled without legal redress. The costs of equalising pay in local government are an estimated £3 billion.

Long-standing and corrupted, no-longer-performance-related bonus schemes help to explain the size and duration of the gender pay gap amongst local authorities, and research at Exeter University suggests that they may unwittingly be generating more unequal pay far more broadly across the economy. The researchers found that women in executive positions in the private sector earned significantly smaller bonuses, on average, than their male counterparts in equivalent positions, and particularly in years of high organisation performance.

Not enough macho risk-taking behaviour on show by directors in skirts to warrant equivalent bonuses? It seems tough to explain the gap otherwise, and it makes the Icelandic government's recent decision to put females in charge of two of its spectacularly-failed banks all the more understandable.

The new Equality Bill, published in April 2009, will increase the pressures on recalcitrant employers, with measures to improve pay transparency, force disclosure on suppliers to the public sector, and give wider powers to tribunals. A parallel private member's bill promoted by Theresa May incorporates even more radical measures, such as compulsory equal pay audits in certain situations.

4. 'The labourer is worthy of his reward': engagement and pay

Finally, there is the growing body of research evidence supporting the view that UK employees display low levels of engagement by international standards and that dissatisfaction with pay and fair treatment is a key contributor to this. As the recession and rising unemployment tests the depth of so many employers' recruitment and website claims to be 'great places to work' this is likely to be an increasing area of concern.

Ever since J S Adams outlined his equity theory in the late 1950s, a wide variety of research studies have reinforced his ideas on the importance of relative assessments in determining our satisfaction with rewards. The bulk of those studies appear to suggest that when comparing reward we place most weight on comparisons with our colleagues, rather than the abstract concept of the external market which reward managers now spend so much time obsessing about.

Professor David Guest's research shows that perceived fairness and reciprocity, alongside of trust, are at the core of a positive, engaging and high-performance-generating psychological contract in the workplace. And Professor Katie Truss finds dissatisfaction with pay to be a primary factor limiting the engagement levels of UK employees, with fewer than one third of them trusting their organisation's senior management. Similarly, Stanford Professor Charles O'Reilly claims that huge salary differentials weaken loyalty and erodes the internal talent pool.

Despite the contemporary emphasis on employee engagement, the core ideas of fairness and motivation in reward receive far less emphasis than they did when I came into HR 25 years ago, and there are grounds for fearing that the recession could push them even further into the background, if a 'you should be grateful to have a job' mindset were to re-emerge.

Re-asserting fair rewards

It was in fact Tory Prime Minister Stanley Baldwin who in the aftermath of the 1926 General Strike voiced the opinion that, 'had the employers of past generations dealt fairly with their employees, then there would have been no unions'.

So today, how can we achieve fairer pay, beyond praying for it and hoping to avoid the sort of industrial and social unrest that is premier Singh's fear? I would recommend that priority be given and action taken in four areas.

1. Get strategic

First, develop a written reward strategy which asserts the importance of fair, non-discriminatory pay in your organisation. Of course, you also need to reflect the external market for recruitment and retention purposes, and links between performance and pay will be essential for most, but fairness is just as important in engaging your employees.

Your reward strategy also needs to define what fairness means for your organisation. Some public sector employers have, in my view, made the mistake of running-scared of equal pay law and its sometimes bizarre interpretations in tribunals, by trying to minimise individual pay differences and pay people as closely as possible to each other. This attempt to turn the clock back to grade-driven fixed rates and uniform packages is doomed to fail in our more consumer-driven and far more diverse society and employed population.

And if the complaints I hear in focus groups at employers' continuing failures to address under-performers who are paid the same as the more diligent are anything to go by, then I am not the only one who finds the biblical parable of the vineyard a difficult one to embrace and practice personally. (You might recall the vineyard owner paid those workers who arrived late the same as those who had been picking grapes all day, and the latter complained, as many of us might, at the relative unfairness of this arrangement. In defence of vineyard owners everywhere however, we should note that he paid them all a generous day's wage, and also that this practice was the local (market) custom of the time – neither of which is true of most UK public sector employers today).

In your organisation performance pay may well be a key objective, and there is a lot of evidence that, in principle, many employees will agree with you and think that it is fair that those who contribute more should be paid more. Adams' pay equity theory is not just an assertion of the importance of the judgement of the adequacy of rewards which we make in relation to others. It is also about the assessment we make of the fairness and appropriateness of the balance between the work 'inputs' we provide (time, effort, skill, performance, etc.) and the reward 'outputs' (pay, benefits and non-financial rewards such as recognition) we receive in return.

Another British Prime Minister put it more succinctly. In Disraeli's words 'a fair day's work for a fair day's pay' should be the primary reward objective, a phrase which has perhaps rather unfortunately fallen out of the HR and employer lexicon in recent years.

As in the financial services company described below, the practical difficulties with performance-related pay have tended to revolve around the perceived and actual unfairness of the performance appraisal and management processes, which act as the basis for the determination of pay awards. It is to this area that many employers need to devote more attention if they are going to operate performance-related rewards which are generally accepted and perceived to be fair and motivating. Fair pay and truly performance-related pay are complimentary, not competing reward goals. Ed Montemayor's research with American and Mexican professional workers, for example, found that perceptions of the fairness of pay and performance management processes and decisions was the major determinant of their acceptance or rejection of merit pay systems.

My main point though is that the basis for pay differences needs to be clearly defined and communicated as part of your reward principles, and then managed and practiced in a fair and non-discriminatory manner, with the emphasis in our ultra-cynical age on the reality in practice.

2. Play fair

Second, conduct an equal pay review. You cannot possibly know how to act on fair pay unless you know how fair current reward levels and processes are. What and where are the major earnings gaps and how much of the variation can you explain and justify? Start simple, looking at gender pay gaps at different levels and in different parts of your organisation, and then subsequently extend your investigation. Remember to look at all aspects of reward, including cash supplements and bonuses, as well as base pay. Extend it to compare rewards for different groups and categories of staff, not just gender differences, and look at related processes such as promotions and career development (possibly the major cause of the gender pay gap), and performance management.

Researchers such as Laventhal have also helped us to understand that when making assessments of fairness, employees do not just look at 'distributive justice', that is the absolute amount of how much they receive and in relation to others. They also consider 'procedural justice', ie the fairness of the processes you use to arrive at pay outcomes, such as job evaluation and performance appraisal. This means that you always need to look at employee perceptions, as well as absolute pay rates in your EPR of course.

Fair and equal pay shouldn't be driven by a purely compliance and legislative-driven, risk-management agenda. We are talking about more effectively practicing a fundamental principle of employee motivation. Do you want a reputation as an unfair employer? How would your 'great place to work' claims stand up to that? Fairness is also the basis for moving, not to legislatively-enforced equal pay, but to rewarding diversity, celebrating and rewarding diversity and choice in our organisations, because it's a good and fair and motivating thing to do. Let me give two examples of what I mean.

A financial services company found in its first equal pay review that the anticipated female pay shortfalls originated in recruitment salaries and performance pay awards. Branch managers were unwittingly paying their harder-negotiating male recruits around £1,000 more than females, while the performance rating distributions also showed that rating biases were magnifying the effects of this in subsequent years. They addressed this by re-introducing central monitoring by HR of proposed new-starter pay rates, and by training line managers in non-discriminatory performance appraisal techniques.

Another financial services company included data from its annual engagement survey, as well as actual pay data, in its equal pay review. Using cluster analysis techniques they have actually 'bottom up' grouped staff into 6 different categories according to their needs and motivation profiles. Communications on reward are now tailored to each of these groups. This means that staff are now better educated to take advantage of the extensive but at times complex flexible benefits and reward package that this bank provides.

3. 'Speak and sow, listen and reap': communicate

Third, as in the first financial services example above, train your line managers in fair treatment and reward, and be as open and honest as possible in your rewards communications. As Professor John Purcell's research demonstrates, first-line managers and supervisors are the critical linkage between your reward principles and intentions and their practical delivery, and genuinely creating a truly rewarding environment that is conducive to high employee performance. Yet too often in the face of organisational and HR department re-structuring, they have been left to cope with widening spans of control, increasingly complex and demanding pay and reward systems, and lack of local HR department support.

This is not just about more training, though that would often help. It's also about involving line managers at every stage of the reward management process, so that they understand and buy into the aims of your reward policies and the plans designed to deliver them. At one drinks company, a line manager forum meets with HR and compensation department staff quarterly to discuss the current reward situation and any proposed changes and improvements. I found that when we piloted improvements in the pay review process with line managers in a Scottish financial services company, it reinforced the basic process we had designed, but really helped the HR department to better focus its support in areas line managers needed it, such as appraising under-performers.

Line managers are also of course key to the other major challenge in achieving fair rewards: communications. It matters not a jot that you say fairness is a key reward principle in your organisation. What matters is that employee perceive the principle of fairness to be evident in practice. Talk with HR and reward directors and communications is invariably the aspect of rewards where they will confess to weaknesses and the need for the greatest attention and improvement.

The EOC's guidelines adopted by the EHRC on achieving equal pay rightly emphasise throughout the importance of employee communications and training. My own research with Michael Armstrong on successful pay re-structuring replicated the findings of many other studies: the least successful organisations devoted the least effort and resource to employee communications.

I saw a survey recently purporting to show that over half of us would accept total openness on everyone's pay level in the organisation, as indeed was the case for many years in parts of the public sector. Polly Toynbee favours such an approach with legislative enforcement. I am not convinced. The full exposure of company directors' pay levels if anything seems to have fuelled the fire of executive pay inflation, while I think there is still a cultural reticence in discussing pay in this country that is not evident in, say, North America.

The reaction here would be likely to be similar to that occasioned last year in Italy by a mischievous tax official, who took advantage of yet another interregnum between governments to publish the entire population's tax details on the internet. This on-line equivalent of lifting the net curtains on your neighbours' income occasioned complete mayhem until it was closed down after 24 hours. The secrecy over personal levels of bonus awards in the City, it is true, has provided the context in which discrimination can take place, but that does not mean it is the cause of it. For that, I believe we should be looking at poor performance management and weak governance.

But nonetheless, there is no doubt that your reward methods and their fairness are only as good as the quantity and quality of communications that you deploy in support of them. Asking staff what they think about their rewards and taking account of that in your policies, and then involving them at every stage of the design and delivery of new arrangements, is critical to the success of reward management. According to American psychologist Rollo May, 'communication leads to community, that is to understanding and mutual valuing'.

4. Be of one church

Finally, nobody is saying pay your chief executive the same as your cleaners (though Boris Johnson wrote to London's five premier league clubs recently, suggesting that in the light of the level of their on-field players' salaries, they might want to pay their cleaning catering and support staff a 'living wage'). Any objective assessment of the job size and impact of the former role would produce a figure which is much bigger than for the latter (though quite possibly less than their current total cash differential). The FSA inquiry into City pay was actually primarily directed at the rewards of traders and investment bankers, rather than executives. Pay scheme governance undoubtedly needs to be improved for these groups and HR departments suitably resourced to develop and control incentive arrangements. But similar processes and standards should be applied to all of your employees, of whatever rank, in determining and managing their rewards in a fair and consistent manner.

In particular, executive pay must be set in the context of the rest of the organisation, as well as the market-place. The revised Companies Act of 2007 enshrined in legislation this broader perspective of taking other stakeholder groups, including employees, into account when making board decisions. It is a principle supported by the various reviews of executive pay and governance (Greenbury, Hempel, Higgs etc.) and the investor bodies, one of which recommends that companies publish their chief executive to average employee remuneration ratio in their annual reports.

Investors and remuneration committees have got much sharper in opposing market pay ratcheting, which has seen the average FTSE board annual bonus opportunity, for example, triple to 150 per cent of pay since 2002. They are now much more likely to question how proposed executive base pay increases compare to those in the rest of the organisation, or as Guy Jubb of Standard Life Investments describes it 'put the pay increase genie back in the lamp'.

But, in my view, companies should be going further and reversing the trend towards wholly distinctive reward arrangements for executives. It has become fashionable for example, to take senior executives outside of the job evaluation and pay structures applying to other staff. **Why should there be different methods of evaluation, particularly when so much of the apparently necessary pay flexibility required for executives comes in the form of variable and not basic pay anyway?** How does this help to reassure staff that all employees are being treated fairly and judged equally?

Somelfske and Padgett recommend remuneration committees apply an approach they term Internal Pay Equity to help set executive pay levels in relation to those of other staff, alongside of the ubiquitous external market pay surveys. Du Pont is one of the companies which applies this technique.

Much of the research on sustained high performing organisations seems to support the need for a strong and united sense of mutuality and purpose. A study for example, by Professor Chris Brewster found that high performing companies in Europe were more likely to have all-employee profit sharing and share schemes in place than their competitors. So while bonus opportunities may well differ according to scope for impact on the company results and with shareholder-related measures emphasised at the top, **why shouldn't all employees have the opportunity to share in the financial success of their employer?**

Tesco, our most successful retailer of the last decade, has reported an excellent take-up of its latest all-employee share scheme offer, despite the current depressed stock market. Over 165,000 employees own equity in the company and they benefited to the tune of around £181 million in 2007.

John Lewis, with its corporate aim of providing 'worthwhile and satisfying employment in a successful business' is often cited as a model example of mutuality in this regard, eschewing as it does executive incentives in favour of a common staff bonus, and still managing to be extremely successful and recruit and retain more than half-decent executives.

But I thought it was interesting to see that retiring chair Sir Stuart Hampson had said that, while executive pay is an easy target for politicians, our attention could be devoted rather less to demonising the so-called 'fat cats', and rather more to how we make more of the 'thin cats' fatter. More employers might therefore copy the example of one transport company I have done some work with, where if the general staff bonus plan doesn't pay out, then executive incentives are also cancelled, if the John Lewis bonus approach is a step too far.

Total rewards approaches also need to be a continued area of emphasis in the downturn, and for employees at all levels in your organisation. As Michael Armstrong and Helen Murlis explain, total rewards provide a common framework within which rewards can be varied to take account of different group and individual needs, and 'maximise the impact of a wide range of reward initiatives on motivation, commitment and job engagement'. Our consulting and research on engagement at IES illustrates the diversity of financial and non-financial factors which can contribute to it in different work settings. But perceptions of pay and employment fairness are invariably important contributors.

The reward issues in the City have undoubtedly illustrated that in terms of bonuses, you can have too much of a good thing. We shall hopefully see healthier total reward packages – balancing fixed and variable pay, financial and non-financial metrics and short and longer term rewards – adopted on a more widespread basis in the near future.

'Thou art unified in the balance'

Balance is an important concept that has been under-used in reward circles over the last 20 years. It was through Charles Handy that I first became acquainted with Aristotle's pre-biblical ideas of happiness achieved through 'the golden mean' and the recognition of 'enough'. Virtue, he wrote, was not the opposite of evil but lay in the middle ground between too much and too little.

Handy for one believes that capitalism has become unbalanced, with its exclusive focus on shareholder returns, that have damaged Gordon Brown's cherished civic society and are exemplified in the stock-related rewards of executives that have done much to drive the widening of pay differentials.

He calls for a new morality and mutuality in the way corporations are run, and for better balancing of the interests of all stakeholder groups, including of course employees. 'We need to give more money to those who make the money, to those who live in the house, and less to those who provide the money, the investors' is his conclusion, advocating more social and mutually owned enterprises, along the lines of John Lewis for example. Futurologist Richard Jackson forecasts progress in this direction in 2009:

'To get through this mess we will have to stand together and that means a new emphasis on the well-being of the family, the team, the community, the common good and looking after each other, rather than being selfish individuals'.

Whether through this belief or simply reacting to the social and media pressures externally, we have seen a number of companies such as Pearson Education and ITV in 2009 taking the first steps to reversing the upward trend in pay differentials by freezing pay for their executives while continuing to award increases for lower paid staff.

Passing through the eye of a needle

Business journalist Ruth Sutherland sees two lights of optimism in the generally dire predictions for 2009. First the recession could end faster than we think. Second, 'the pain of the crunch might in the long term lead to a healthier, more balanced economy with less inequality and less dependence on the City'.

Peter Montagnon from the Association of British Insurers believes that 'there are some big questions being asked about executive remuneration' in the current financial and economic malaise. As well as the FSA's review criteria, I think remuneration committees might also address two further 'big' questions in the current climate. First, do our executive remuneration arrangements need to be quite so isolated, complex and opaque? Here, we can already see plenty of examples of this question being asked, not just by the FSA, and even the odd example of scheme design simplification underway.

But secondly, as we see employees in companies such as JCB accepting pay cuts to preserve the jobs of colleagues, they might also want to ask themselves a question I have never seen addressed by a remuneration committee, but in our current economic and social climate seems vital: just how much is enough?

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The Holy Bible

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If you would like to talk further about dealing with the issues raised in this paper or any of your HR challenges (be they reward, development, planning, motivation etc), then please contact:

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