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Five Strategies to Promote Pay Equity

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Pay inequities can create significant risks for employers. Employees, either individually or as a group, can sue their employer. Those employers can find it difficult to comply with a patchwork of federal, state and local laws, as well as assess their risk under an array of different regulations and reporting requirements. Plus, shareholders are increasingly demanding that organizations disclose pay parity information or even unadjusted raw pay gaps.

Most employers want to do the right thing. A pay audit can be an important first step to reveal statistically significant pay gaps based on gender or race/ethnicity, providing statistical insights into an employer's potential areas of legal risk. It equips the employer to pay employees more fairly, reveals the implications of current pay practices and can also identify the lingering influence of past decisions. Further, an audit may improve the organization's image as a progressive employer.

Once a gap is identified, employers may struggle with how to best respond to a complex set of legal questions and practical implementation issues. This article focuses on the implementation issue and examines five mitigation strategies for an employer to consider. For clarity purposes, this article simplifies a myriad of mitigation strategies used by employers of varying sizes and industries.

DEVELOPING A MITIGATION STRATEGY

Setting an action plan

After conducting the pay audit, the employer has three key decisions to make:

- What groups to mitigate?
- Who is eligible within those groups?
- What budget is needed to narrow or close the gap within each group?

The courts generally conclude that group differences in excess of -2 standard deviations (which is approximately equal to a p-value that is less than 0.05) are unlikely to have occurred by chance alone (Hazelwood 1977). When the group difference is statistically significant, the burden is on the employer to explain the difference. As such, employers typically choose to mitigate group differences at a threshold below -2 standard deviations (e.g., -1.5) to build in a buffer. It is important to remember that a pay analysis is conducted at a particular point in time. The outcomes will change as new employees enter the population, employees terminate and other employment transactions take place. Hence, in managing legal risk, it is often useful to build in a buffer to continue to manage risk over time.

BUDGET

A mitigation budget accounts for the number of protected employees, the magnitude of the pay difference for the group and the employer's target standard deviation. Some employers may wish to completely close an identified gap and will budget accordingly. For example, if the model reveals that a group of 100 women are underpaid by an average of $3,000 each, a budget of approximately $300,000 will be needed to reach parity. In practice, many employers budget to reduce gaps to statistical or practical insignificance rather than trying to close them completely.

Typically, adjustments are limited to the gender or race/ethnic group that is statistically significantly underpaid or in excess of the targeted standard deviations (e.g., the protected or target group in this example is women) after accounting for the factors in the pay model. Sometimes employers adjust individuals in the comparison group to provide some cover for the equity project or because they want to ensure that all employees are paid equitably. However, if in our example the employer adjusts male pay, the female budget would need to be increased.

FIVE APPROACHES TO MITIGATING PAY INEQUITY

To a large extent, an employer's size, available staffing and financial resources will determine which strategy is the right fit. It may not be feasible for a resource-thin

business to review hundreds of pay decisions at the individual level or implement an approach using complex computations. Smaller employers also have comparatively less risk due to their smaller populations and fewer employees driving statistical significance. Larger organizations with more employee groups often take a programmatic approach to mitigation.

Approach 1: Cohort Review of All Targeted Employees

A cohort review ensures that there are no important factors omitted from the pay model and that appropriate decisions are being made on an individual basis. If the group is large, then employers can select a sample of the most underpaid protected and overpaid comparator individuals to review as a first step. Individual review is critical to ensure that the model accurately reflects the key decision-making factors. The ideal mitigation strategy is to review each protected employee in the group and make adjustments relative to their cohort.

If cohort review supports insights drawn from the model, it can be helpful to understand the underlying pay distributions between the protected and comparator groups. In the following examples, the protected group is women and the comparator group is men.

Approach 2: Targeting Outliers

The second approach to mitigating pay inequities is to target pay increases only for outlier individuals who are found to be driving statistical significance. This approach may make sense where compensation for some female employees is significantly out of step with that for men.

Figure 1 shows the normalized difference (i.e., the standard deviation) between an employee's actual pay and the applied model's prediction of what that employee should be paid given characteristics accounted for in the model, with the zero point representing employees whose compensation is equal to what the model predicts. The medium gray area illustrates where women are within the distribution while the light gray area shows where men are in the distribution. The area plotted on the horizontal axis to the left of zero indicates the density (or frequency) of employees paid less than the model predicts and the area plotted to the right of zero indicates the frequency of employees paid more than the model predicts. Note that a cluster of significantly underpaid women appears at the far left, potentially driving the group gender pay difference.

When working with results such as these, a close look at the underlying population may show that the model did not adequately account for factors that could explain the lower pay of women in the underpaid outlier group. The lower pay of an outlier population may be legally justified. For example, the organization represented in Figure 1 might find in the cohort review of these several women that they are working on projects that are less technically involved, and so their pay reflects a contribution that is not as valuable to the organization. Provided that the discrepancy

FIGURE 1 First Hypothetical Distribution of Group Difference by Gender

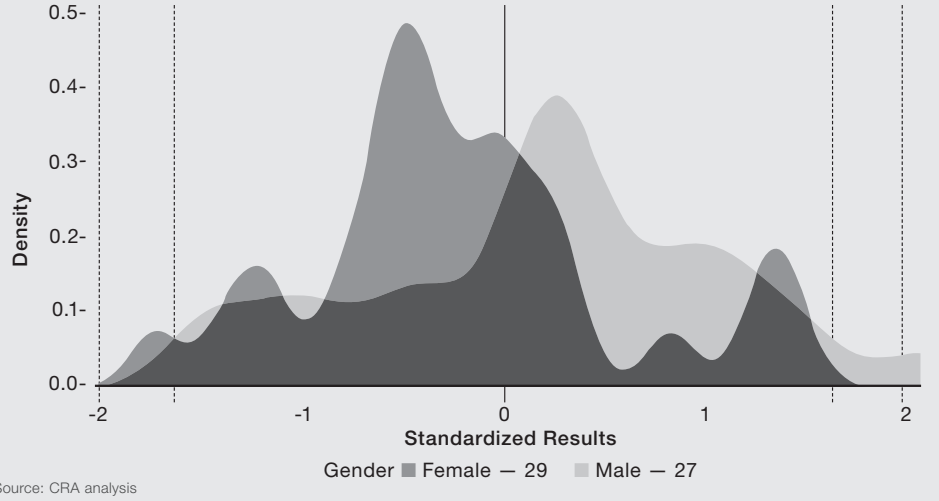
Source: Charles River Associates (CRA) analysis

can be justified with a legally defensible rationale, it might not need to be mitigated. If the permissible factor can be quantified, it can be added to the analytical model to confirm whether the justification explains the full wage differential.

Approach 3: The Peanut Butter Approach

Figure 2 reflects a distributional shift between pay for men and women, with women on average earning a little less and men a little more. This is a common scenario where there is no obvious outlier group, but rather a consistent discrepancy between the two groups.

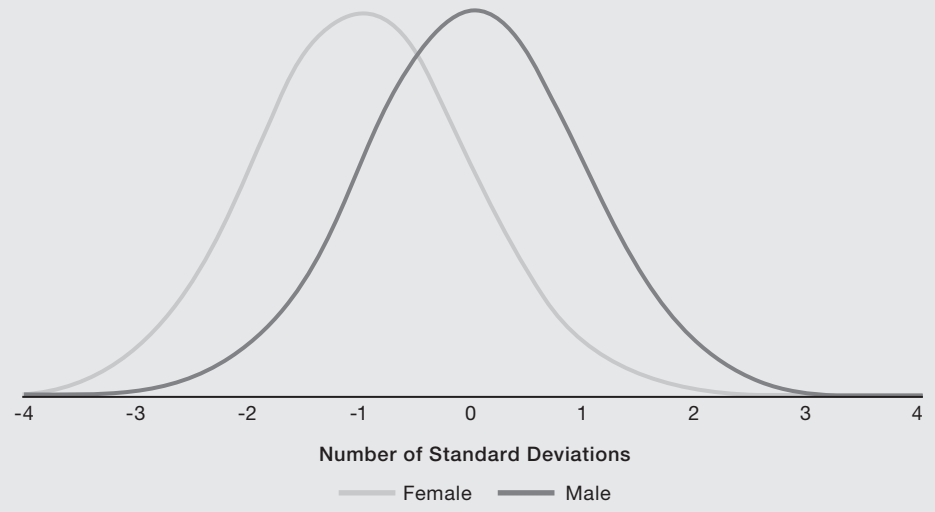
FIGURE 2 Second Hypothetical Distribution of Group Difference by Gender



Source: CRA analysis

Figure 3 provides a simplified version of the data shown in Figure 2. The female pay distribution, illustrated with the medium gray curve, is shifted to the left of the male pay distribution, which is represented by the light gray curve. Targeting underpaid female outliers (strategy 2) is not an effective mitigation strategy when the group difference is driven by a shift in the entire distribution.

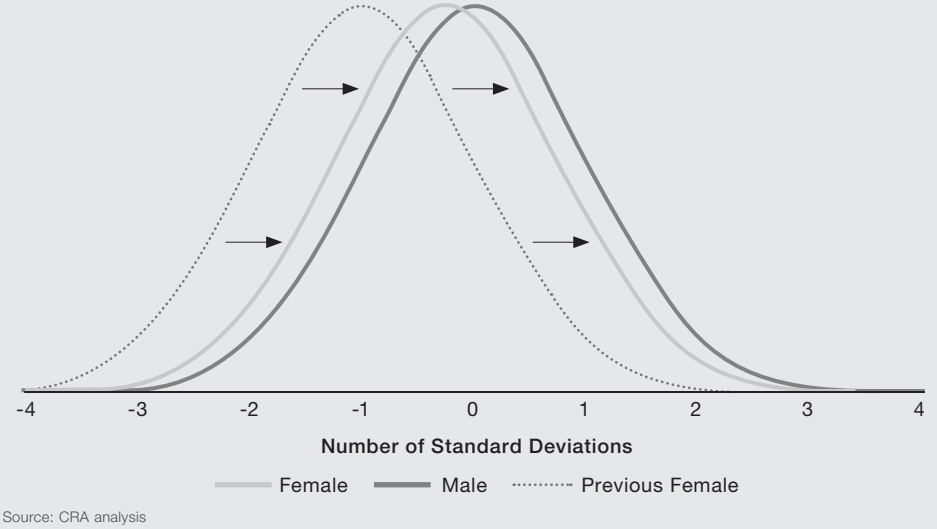
FIGURE 3 Simplified Residual Distribution by Gender, General Distribution Difference



Source: CRA analysis

One effective strategy would be the so-called "peanut butter approach," which spreads the mitigation budget evenly across the entire target population, with the goal of shifting the entire population into better alignment with the comparison group.

FIGURE 4 Results of the "Peanut Butter Approach" on Residual Distribution by Gender



Source: CRA analysis

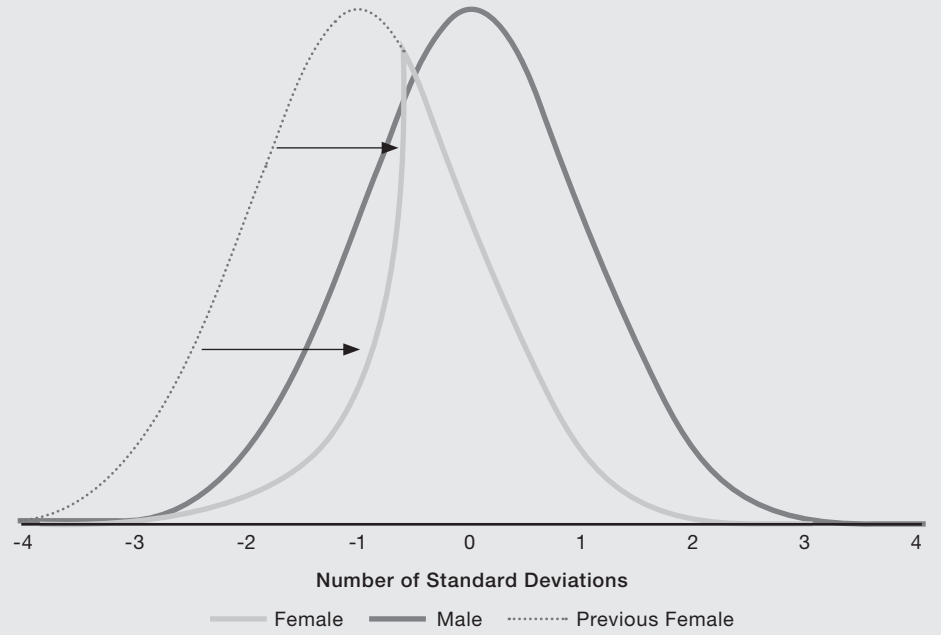
The peanut butter approach is often seen in class-action settlements, where a simple, easy-to-apply solution is preferred. This approach does not alter the variance of the female population (it makes no changes to the overall width of the female pay curve), which can be advantageous because reductions in the variability in pay make it easier for the group difference to become statistically significant. A downside of this approach is that it rewards individuals who may be underpaid for a legitimate reason. These changes are more likely to be undone in future salary adjustments.

The peanut butter approach may make sense in the retail context, where a large population of store managers is found to have a small but statistically significant pay gap. In this case, spreading the budget over the whole population may be the simplest and most cost-effective solution. If the individual adjustments are small relative to the salary, then an individual review of the equity adjustments may not add much value, especially considering the time and effort required.

Approach 4: Adjustments Only to "Underpaid" Employees

One way to avoid increasing the pay of highly compensated members of the target group is to increase pay only of employees who are found to be below the model's predicted pay. Figure 5 illustrates the results of this approach.

FIGURE 5 Effect of Mitigation Targeting Population Below Predicted Salary



Source: CRA analysis

Employers that do not opt to increase the pay of women paid more than the model predicts often limit adjustments to women paid less than the model predicts. Compared to the peanut butter approach, the more targeted solution results in the budget being allocated to a smaller group of employees. The more highly compensated members of the group are generally excluded. On average, this results in a bigger adjustment per employee. In some cases, this can result in large pay increases for some employees, requiring employers to spread out the increase over a number of years.

A common, but unintended, consequence of this approach is leapfrogging, where employees who were low on the distribution are adjusted out of sync with what may have been justifiably lower wages. This result is more likely to occur if the employer lacks the resources to conduct an analysis at an individual level, but instead needs to apply a systematic solution across a broad group. This approach puts a lot of faith in the accuracy of the pay model. To work, the model needs to correctly capture the data for the studied population. Without adequate information or implementation resources, the women who began at the low end of the distribution in Figure 5 might end up more highly paid than the men with whom they should be at parity.

The solid light blue line in Figure 5 shows how raising only the bottom end of the scale results in a tightened variance structure (less variation means the model will be better at predicting salaries). Going forward, such a structure makes the affected population more likely to have statistically significant pay differences.

Approach 5: Model Equity Adjustments Using Market Pay Range and Performance

Many employers use market data to ensure they are competitively paying employees and set guidelines for manager discretion. Market pay ranges are often used in the merit increase process, with adjustments in part determined according to how far into the market range an employee has penetrated. Adjustments typically get smaller as an employee approaches the top end of the market range and employees with better performance typically receive larger adjustments. This framework allows for top performers who came in with a lower salary to catch up quickly. It also applies the brakes to salary growth as employees become more tenured in their position.

A similar pay increase philosophy can be applied when making equity adjustments. This method is technically more complex to execute and requires that employers maintain current market pay data (preferably for each job title) and use an ordinal performance rating system. The employer would be prudent to confirm the performance ratings are not subject to the same bias that may be involved in setting pay. Any employer that wishes to include performance in its pay model should conduct a performance validation study to confirm that gender and race/ethnicity are not determinants of the rating outcomes. Otherwise, the employer could remediate a model without performance as a control, but use the review in the allocation process.

This approach appeals to employers that want a strategy that aligns with their pay-for-performance compensation philosophy. This strategy is also desirable as it helps preserve the relative pay relationships because, on a percentage basis, it spreads the budget across the majority of the group using factors already applied by managers in the merit increase process.

FINAL THOUGHTS ON MITIGATING PAY INEQUITIES

In practice, an employer's mitigation strategy is often a combination of multiple techniques. Regardless of the approach, many important decisions often need to be made during the mitigation process. Should poor performers be eligible for increases? Should pay increases be capped at a certain level? Should increases be incorporated into the existing merit increase cycle to reduce the mitigation effort's visibility? Should adjustments be done at once or spread over a number of years?

The answers to such questions often need to come from several places within a company. Reaching consensus about goals can be important for getting everyone pulling in the same direction.

Once the employer selects and implements a mitigation strategy, it needs to rerun the pay model to confirm that the proposed pay of all employees accomplishes the goals of the project and did not introduce new, unexpected problems in populations that were not targeted.

Pay audits offer the employer an opportunity to learn. The process can provide valuable insights into a company's pay structure and management culture. It can reveal underlying causes for underpayment, policies that may need review for compliance and best practices and areas where managers need further training. An audit can also reveal new strategies the employer might take to reduce the influence of past decisions and prevent those past policies and practices that contributed to the pay differences in the first place. ▮

EDITOR'S NOTE

The views expressed in this article are those of the author and do not reflect the views of Charles River Associates or any of the organizations the author is affiliated with.

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Hazelwood School District v. United States, 433 U.S. 299 (1977).