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SEARCHING FOR PAY EQUITY: THE ROLE OF PAY COMPRESSION ON INDIVIDUAL-LEVEL OUTCOMES

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Abstract

Pay compression occurs when employees with more seniority receive pay rates nearly equal to newer employees. Based upon equity theory, we hypothesize that pay compression will influence employee perceptions of pay equity. We find that pay compression is negatively related to pay equity and that these perceptions are related to organizational commitment and intentions to turnover. We also find that pay equity mediates a relationship between pay compression and employee intentions to leave the organization.

Decisions concerning the manner in which pay is distributed among employees are of significant concern to today's organizations. Research has shown that the allocation of pay highly influences key employee attitudes and behaviors including job satisfaction, organizational commitment, and job performance (e.g., Bloom & Michel, 2002; Greenberg, 1990). One aspect of compensation systems that has recently received increased attention for its potential effects on employee attitudes and retention is "pay compression and inversion." Pay compression occurs when new hires are brought into an organization at pay rates nearly equal to (compression) or greater than (inversion) existing employees (Glandon & Glandon, 2001; Gomez-Mejia & Balkin, 1987). For example, a number of studies have investigated problems associated with university salaries in which more junior faculty are paid the same or more than long-tenured faculty of higher rank (Brown & Woodbury, 1998**;** Glandon & Glandon, 2001; Huseman, McHone, & Rungeling, 1996; Jennings & McLaughlin, 1997). In 2003, the U.S. Senate held hearings to address the impact of salary compression on the retention of senior civil service employees (Barr, 2003). Although the concept of pay compression has been written about for at least 25 years, very little systematic research exists aside from studies of university faculty. The purpose of this paper is to examine effects of pay compression in the private workplace on individual organizational commitment and intention to turnover.

Compression most commonly occurs when the salaries of organizational members do not grow with external market wage rates and more recently hired employees are paid the same or more than long-tenured employees (McCulley & Downey, 1993). When companies are designing a pay system, they often simultaneously use both external labor market surveys to establish pay rates, along with internal job evaluation systems in which the worth of a given position is determined in relation to organizational strategy and design (Gerhart & Rynes, 2003).

Research has shown that pay compression may be an outcome when organizations focus more heavily on the external market pressures (an external equity strategy) than on internal job evaluations (an internal equity strategy) when determining wage rates (Weber & Rynes, 1991). When organizations emphasize external equity in compensation practices, they erode the pay discrepancies between experienced employees and organizational newcomers. Consequently, existing employees may feel that length of service, organizational knowledge, and continued loyalty are not viewed as important by the organization and need not be rewarded (Glandon & Glandon, 2001).

In this study we define pay compression as a decline in the value of additional years of tenure over time, resulting in a situation where employees are paid less than would be predicted by their years of seniority. This definition of pay compression differs from a number of studies that have examined variations in pay at the organization level and have defined pay compression based simply upon the degree of variation present in the compensation structure (e.g., Bloom, 1999). Our definition of pay compression focuses on an individual employee's relative position within a pay structure combined with his or her years of experience with the organization and is similar to the one proposed by Glandon and Glandon (2001) and Milkovich and Newman (1996). That is, pay compression is determined by the relationship between seniority and salary and the narrowing of pay differentials between employees with differing levels of experience.

Based on equity theory, research has shown that individuals are concerned with how their compensation level relates to that received by others in the organization (Bloom, 1999; Bloom & Michel, 2002). Such comparisons are made in an attempt to determine one's relative worth to the organization in terms of value and status (Folger & Cropanzano, 1998). Additionally, employees often perceive that the magnitude of their pay is a reflection of their performance and abilities

(Bloom & Michel, 2002). Multiple studies have concluded that employees tend to justify variations in pay rates if the relative worth of the employee and their contributions differ (Gomez-Mejia & Balkin, 1987; Pfeffer & Davis-Blake, 1992). Under these conditions, pay discrepancies are viewed as equitable and fair. However, problems arise when the differentials between individuals are not as large as employees might expect.

Pay compression matters because minimal variations in pay among individuals with perceived differences in qualifications or job performance and value can result in feelings of inequity. If individuals believe that their contributions to the organization are undervalued, attitudes toward the organization will suffer as a result (Bloom & Michel, 2002; Gomez-Mejia & Balkin, 1987). Consequently, how long-tenured employees are rewarded represents a key compensation decision for all organizations. Since relative pay differences have been shown to influence job attitudes and multiple aspects of employee behavior including intentions to remain with an organization (Bloom, 1999; Bloom & Michel, 2002; Lazear & Rosen, 1981), the understanding by organizations of the influence that pay compression has on employee attitudes and behavior is essential in order to effectively design a successful compensation system.

Compression, Dispersion, and the Role of Seniority

Nearly all of the prior research focusing on this compensation issue has debated the organizational outcomes associated with dispersed versus compressed pay systems (e.g., Bloom, 1999; Bloom & Michel, 2002; Gardner, 1999). This previous research defines compression and dispersion more broadly as the overall distribution of pay at the organizational level and characterizes the entire organization as either dispersed or compressed based upon the range of pay rates within the organization (Bloom & Michel, 2002; Brown, Sturman & Simmering, 2003). Those organizations utilizing a dispersed pay structure have large variations in pay rates among

employees and several levels of pay available. The wide variations and hierarchical structure of pay allows employees to progressively move to increasingly higher rates of pay (Bloom, 1999; Gardner, 1999). Shaw, Gupta, and Delery (2002) found that pay dispersion should serve as a motivator of performance and pay differentials must be high enough to produce such motivation. These studies of extensive pay dispersion argue that it will provide incentives for increased performance, attract a better workforce, and enable organizations to retain their best performers.

A clear alternative to highly dispersed pay systems is a system in which little dispersion in wage levels is present within job types and few differences in pay exist between an organization's members. Such systems can be viewed as relatively flat based on the limited amount of variance in employee wages and have been found by some researchers to be beneficial to organizational performance by reducing competition between an organization's members and encouraging cooperation (Bloom, 1999; Pfeffer & Langton, 1993; Shaw et al., 2002). A lack of variance in wages can reduce friction and enhance productivity (Pfeffer & Davis-Blake, 1992) by creating a more egalitarian environment than in highly dispersed systems (Bloom & Michel, 2002). Bloom (1999) and other supporters of this type of pay structure propose that the large pay differences associated with extensive pay dispersion create feelings of injustice among employees thereby reducing their mutual commitment to the achievement of organizational goals.

Results of these studies differ significantly regarding the likely effects of pay dispersion on organizational and individual performance. More dispersed pay distributions have been positively related to individual and organizational outcomes in some studies (Shaw et al., 2002) and negatively related to such outcomes in other research (Bloom, 1999). Such conflicting findings have led researchers to investigate the effects of additional influences in determining the

appropriate compensation structure (Bloom, 1999; Bloom & Michel, 2002; Shaw et al., 2002). We suggest part of this debate might be resolved by looking instead at the reactions of individual employees to variations in pay within organizations as opposed to differences in overall dispersion among organizations. For example, Shaw and colleagues recommend that widely dispersed pay systems should only be applied when the variations in pay are "attributable to legitimate sources" (Shaw et al., 2002: p. 507). The current study of pay compression examines the importance of variations in pay derived from seniority and job classification. Specifically, how do individuals react to pay levels that are similar to or lower than less-tenured fellow employees in similar jobs?

When organizations find themselves operating in markets in which there is a high demand for new employees, they are forced to raise the starting pay rates of newcomers in order to attract them (Gomez-Mejia & Balkin, 1987). However, such organizations often fail to continuously adjust the pay levels of existing employees in a similar fashion (Gomez-Mejia & Balkin, 1987). As a result, pay compression occurs because individuals entering the organization are paid at similar levels to employees who have been with the organization for a longer period of time. Because existing employees rarely see raises that keep pace with the external labor market in which pay is increased to attract desired talent, erosion in pay differentials between organizational newcomers and longer-tenured employees can occur in any growing field in which demand for talent is high (Brown & Woodbury, 1998).

The presence of salary compression directly influences the returns to seniority realized by experienced employees with regard to earnings. The theory of specific human capital predicts that wages will consistently rise with seniority (Hallock, 1995; Toppel, 1991) because the firm-specific skills of the worker increase the longer they remain with a particular organization

(Brown & Woodbury, 1998). Although such returns to seniority can differ between organizational context (Abraham & Farber, 1988) and occupation type (Buckley, 1985), this positive correlation between wages and seniority represents an effort to retain experienced employees (Abraham & Farber, 1987). However, studies have shown that the majority of wage growth occurs during initial employment periods (Brown, 1989) and during changes in organizational setting resulting from job shopping (Altonji & Shakoto, 1987). Consequently, it appears that the theory of specific human capital may not always hold true and that earnings do not significantly rise with seniority in many settings (Abraham & Farber, 1987; Altonji & Shakoto, 1987; Brown & Woodbury, 1998). This suggests the conditions for pay compression may be pervasive in the private sector as well as government and academia as previously discussed.

In this paper, we attempt to build on the research which has focused on the organizational-level implications of overall compensation structures by examining the individual-level effects of pay differentials that cannot be attributed to seniority and job type. When the returns to seniority begin to erode and pay differentials disappear, the question arises as to whether long-tenured employees see the pay dispersion and their own salary level as legitimate and equitable. To understand the extent to which an individual employee's pay is compressed and predict the effects of the organizational pay structure on individual-level outcomes requires an understanding of the literature on perceived pay equity.

Considerations of Pay Equity

According to equity theory, an individual judges their inputs, (years of experience, education level, productivity, etc.) and outcomes (salary, benefits, etc.) relative to the inputs and outcomes of a referent other (Adams, 1965). Inputs represent employee contributions to the

organization while outcomes refer to the personal gains resulting from employment. If the resulting ratios are equivalent, then equity is present. However, if such ratios are out of balance, feelings of inequity will result. Creating differentials in pay between individuals with varying levels of experience is a common method for establishing pay equity (Scholl, Cooper, & McKenna, 1987). The current study focuses on pay compression as the relationship between salary and organizational tenure within a specific job grade. Based on this definition, compression is the absence of differentials occurring across individuals of differing input levels of seniority. In other words, the presence of pay compression will create an inequitable imbalance. New employees with less experience than existing employees may receive the same, more than, or close to the same pay rates. As a result, the existing employees may feel that their additional inputs (greater experience) are not being rewarded in terms of realized outcomes.

Organizations may attempt to justify the high salaries for newcomers based on the argument that market forces dictate these rates in order to attract new employees. However, in most cases, individuals do not associate these external forces with the referent other's personal inputs. Therefore, they do not consider these factors when comparing input/outcome ratios to generate their perceptions of equity. As Lazear (1989) proposed, similarity in pay among individuals in a relative group (e.g., with the same level of experience) is desirable if balanced with differences among individuals of differing levels of experience and demonstrated performance. If not, perceptions of pay inequity will result.

Previous studies of pay equity have examined the relationships between salary and personal factors.and found significant variations due to increased experience, education, and social standing and demographic differences (Desmarais & Curtis, 2001; Mutari & Figart, 1997; Werner & Ones, 2000). While each of these personal determinants is certainly important in

predicting how equitable individuals believe their pay to be, the influence of other interactions must be considered as well. We suggest that the relationship between salary level and seniority within job categories is one of the most critical in creating perceptions of pay equity. Therefore, sensitivity to seniority when newcomers to the organization are receiving similar pay rates as existing organizational members will translate directly into a negative impact of pay compression on pay equity. Hence, the following hypothesis:

Hypothesis 1: Pay compression will have a negative relationship with perceptions of pay equity for organizational members.

It is important to note that we predict a negative relationship with perceptions of pay equity only for those employees experiencing pay compression. The same relationship is not predicted to hold for those individuals who are not compressed. In other words, as pay compression increases, perceptions of pay equity are predicted to fall. However, when pay compression ceases to exist and individuals begin to receive more pay than would be predicted based upon their years of seniority, a positive relationship between lack of pay compression and perceptions of pay equity will not be present. Prior research in this area has demonstrated that the reactions to positive inequity, inequity in the employee's favor, will differ considerably from those associated with negative inequity (Gerhart & Rynes, 2003). Equity theory proposes that as individuals are paid more than employees with better qualifications or job performance, they will tend to rationalize the incongruency and not respond in the same manner as those who are experiencing negative inequity (Adams, 1965). Therefore, the resulting attitudinal and behavioral outcomes will differ. Thus, this study focuses on those individuals who are the victims of pay compression and predicted to experience negative inequity.

Outcomes of Perceived Pay Inequity

Based primarily on the predictions of equity theory, the distribution of rewards within an organization has been linked to a number of different employee attitudes and behaviors such as job satisfaction, organizational commitment, and withdrawal (Bloom, 1999; Bloom & Michel, 2002). As discussed earlier, equity theory proposes that the amount of pay one feels entitled to receive is influenced by what one observes being received by referent others (Scholl et al., 1987). Adams (1965) proposed that when input/outcome ratios are out of balance, individuals can take certain steps to alleviate such discrepancies. If employees feel that their outcomes are not high enough in relation to their inputs when compared against a referent other, they can choose to decrease their inputs or increase their outcomes in an attempt to restore equity (Adams, 1965). Resulting changes can then be observed in employees' attitudes and behavior. In this study, we examine the impact of equity perceptions on organizational commitment and intentions to turnover.

Organizational commitment represents the attachment that an individual feels for a particular organization and is proposed to consist of three forms: affective commitment, normative commitment, and continuance commitment. Affective commitment, in particular, represents "one's liking for a job and emotional attachment to an organization" (Mitchell, Holtom, Lee, Sablynski, & Erez, 2001; p.1106). Multiple studies have shown that affective commitment, at least in part, is determined by the exchange relationship between firms and individuals (Meyer & Smith, 2000; Tsui, Pearce, Porter, Tripoli, 1997). Consequently, we predict that an employee's affective commitment will fall as perceptions of inequity rise. However, pay compression should not have direct effects on organizational commitment since it is not the compression itself, but rather the individual's interpretation of the situation as

inequitable. Individuals engage in a process of evaluating how fairly they believe they are paid which then, in turn, affects their emotional attachment to their organization. Hence, the following hypotheses:

Hypothesis 2: As pay equity decreases, affective organizational commitment will decrease.

Hypothesis 3: Perceptions of pay equity mediate a negative relationship between pay compression and affective organizational commitment.

In addition to affective organizational commitment, pay compression is also likely to affect an employee's willingness to remain with an organization. Traditional turnover theory focuses on job attitudes and job alternatives as the two main factors predicting turnover (Bluedorn, 1982; Hom & Kinicki, 2001; March & Simon, 1958; Mobley, 1977; Mobley, Griffeth, Hand & Meglino, 1979; Steers & Mowday, 1981). When employees perceive pay inequity due to compression, they may withdraw affective attachment to the organization which makes their present job less attractive. More directly, employees with salaries significantly below the external labor market wages for their skills are more likely to have acceptable job alternatives. Victims of pay compression who observe other employees realizing greater financial returns by entering an organization will be more likely to see opportunities for increasing their salaries outside their present organization. We predict that perceptions of inequity and the presence of external job opportunities with greater pay that can result from pay compression will combine to increase intentions to leave the organization. However, pay compression itself should not have a direct effect on employees' intentions to leave the organization as there may be other factors which influence whether they assess the pay they currently receive as equitable. Pay compression would only lead to an increased perception of job opportunities if the employees

felt that the pay they received was inequitable. That is, their pay did not accurately reflect the labor market value of their skills and experience. Consequently, we propose the following hypotheses:

Hypothesis 4: As pay equity decreases, intentions to leave will increase.

Hypothesis 5: Perceptions of pay equity mediate a positive relationship between pay compression and intention to turnover.

Figure 1 presents the model of the hypothesized relationships between pay compression, perceptions of pay equity, affective commitment, and employee intentions to leave.

Insert Figure 1 Here

METHODS

Sample and Procedure

The effects of pay compression are tested using archival and survey data from a sample of salaried technical employees in a large, high-technology manufacturing firm. Engineers and technical managers from a business unit responsible for designing large and complex systems for manufacturing worldwide were surveyed. The employees represent different technical specialties but nearly all were engineers including titles such as: "Project Engineer" (25.8%), "Engineer" (18.8%), "Development Engineer" (14.8%) and "Senior Engineer" (13.8%). There were 24 job titles total among the employees examined.

The firm's compensation system for salaried employees is based on six job grades "broad-banded" to include a large range in salaries for the jobs in each grade. However, within-

grade raises are tightly controlled and employees typically receive only across the board cost of living raises and year-end bonuses based upon individual performance. Other raises or market-adjustments in salary would require a promotion to the next job grade. Ranges for each salary grade were available to all employees, while individual salary information was confidential.

Surveys were conducted as part of a larger multi-organization study in January 2000. A single research and design unit was selected because of the relative comparability of the work performed by salaried employees across the unit. A total of 1,154 employees were surveyed, and usable surveys were returned from 481 employees for an effective response rate of 41.7%. The company also provided electronic, archival, human resource records for all surveyed employees including organizational tenure, salary, race, gender and prior-year performance rating.

Hypothesis 1 is tested using hierarchical ordinary least squares (OLS) regression to examine whether pay compression derived from archival data predicts perceptions of pay equity measured in the employee survey independent of a number of control variables. Hypotheses 2 and 4 which predict that perceptions of pay equity affect organizational affective commitment and intention to turnover are tested using OLS regression. Finally, Hypotheses 3 and 5 which predict the pay equity mediates a relationship between pay compression, organizational commitment, and intention to turnover are tested using the three-step procedure described by Baron and Kenny (1986). First, the independent variable (pay compression) is regressed on the hypothesized mediator (pay equity). Second, pay compression is regressed on the dependent variables, organizational commitment and intention to turnover. Third, if these relationships are significant, then mediation is shown if the mediator still predicts the dependent variable while controlling for the independent variable. That is, if pay equity is significant and pay compression is no longer significant, then complete mediation is demonstrated.

Measures

Pay compression. Previous compensation studies have used a number of different measures to operationalize pay dispersion at the organizational level including "gini" coefficients (Brown, Sturman & Simmering, 1999; Bloom, 1999; Bloom & Michel, 2002; Shaw et al. 2002) and a "coefficient of inversion" which measures the probability that a more senior employee will have higher compensation when two employees are selected randomly in an organization (Jennings & McLaughlin, 1997). However, these measures are used to describe an organization or sub-population rather than the compression experienced by individual employees relative to their colleagues.

In the only previous individual-level study of pay compression, Gomez-Mejia and Balkin (1987) created two ratios by dividing the pay of individual business school faculty members by the average pay of all "newcomers" in the college or all "newcomers" of the same rank. These measures were labeled "overall" and "within-rank" pay compression, respectively. Applying this measure in a private employment setting, however, poses a problem because defining "newcomers" as those with less that two years with the organization is somewhat arbitrary when an organization hires continuously rather than in annual cycles as found in academia. Moreover, this measure does not take into account additional years of seniority beyond the two years, after which employees are no longer considered newcomers. Using the Gomez-Mejia and Balkin (1987) measures, an employee who had been with the organization for 20 years would have the same compression ratio as an employee of the same salary and rank who had only been with the company for 3 years.

To overcome these problems, we have created a new measure which better captures the relationship between tenure, job grade, and salary. Pay compression is operationalized as the

standardized residual of an OLS regression of company seniority and job grade on the employees' salary. Standardized residuals were then used as measures or pay compression. Using the standardized residual yields a continuous variable that reflects the variance in each employee's salary that cannot be explained by either years of seniority or job grade. Employees with negative residuals are paid less than what would be predicted by their job grade and years with the company and are therefore "compressed". This measure best fits our definition of pay compression as declining returns to seniority over time. In practice, this situation appears as eroding pay differentials between organizational newcomers and existing employees.

Tenure is coded from human resource records as the number of years between the employee's original start date and June 2000. Tenure ranged from less than a year to 48 years with a mean of 12.2 years with the company. Salary level is defined as the salary of the employee as of June 2000 when the survey was administered. Mean salary level for the sample was $68,030. Because the firm's compensation system is based on grade, five dummy variables for job grade were included with grade 3 removed as the referent category. This technique means that each employees' pay compression is based on comparisons with other employees in their own particular job grade. Standardized residuals were then used measures of pay compression.

Perceived pay equity. Perceived pay equity was measured using three items written for the employee survey based on previous work in this area (Blau 1994). Responses were gathered using a 5-point Likert scale, ranging from 1 "Strongly Disagree" to 5 "Strongly Agree." Pay equity items were: "My pay is fair considering what people in other companies are paid," "My pay is fair considering what other people in my company are paid," and "All in all, my pay is about what it ought to be." Research has shown that when individuals make comparisons with

referent others to determine equity perceptions, they typically utilize both internal and external referents (Scholl et al., 1987). Therefore, these items simultaneously address considerations of both internal and external equity in an attempt to derive overall perceptions of pay equity. The reliability of the combined items produced a Cronbach's alpha of .86.

Organizational commitment. Affective organizational commitment was measured in the employee survey using a five-point Likert scale. Six items were selected from Porter et al.'s (1974) OCQ to represent employee affective commitment. These items included "I am extremely glad to have chosen this organization to work for over other organizations," and "For me this is the best of all organizations for which to work." Cronbach's alpha for organizational commitment was .87. Several studies have found that the OCQ contains several items that commonly cross-load with intention to stay or intention to turnover measures (Angle & Perry, 1981; Bozeman & Perrewe, 2002; Ferris & Aranya, 1983). To overcome this problem, items were selected from Porter et al.'s (1974) measure that focus only on affective attachment and items with potential overlap with intention to turnover items were eliminated.

Intent to turnover. Intention to turnover is measured using a single survey item in which respondents indicated the extent to which they agreed with the statement: "I plan to look outside my organization for a new job within the next year." This item was written for this survey, and is similar to other intention to leave items common in the literature such as, "What are the chances you will quit your job in the next 12 months?" (Davy, Kinicki & Scheck, 1997; Hom, Griffeth, & Sellaro, 1984; Hom & Griffeth, 1991; Johnston et al., 1993). Although a single-item scale is never ideal, this item was selected to prevent cross-loading with the organizational commitment scale. Additionally, Wanous, Reichers, & Hudy (1997) reported that a single-item scale is sufficient provided the construct is sufficiently narrow and unambiguous.

Education. Employees reported their education level in the survey according to a seven-point scale with high school education as 1 and increasing levels through a Ph.D. as 7. Because engineers constituted the largest portion of the sample, the educational attainment of the respondents was relatively high. More than half of the employees held four-year college degrees, compared with less than 5% who had high school or two-year degrees. One-third of the employees held master's degrees or higher.

Race and gender. One of the most researched topics in the pay and compensation literature has been gender and racial equality in pay (e.g. Desmarais & Curtis, 2001; Mutari & Figart, 1997: Werner & Ones, 2000). Dummy variables were included in each regression for women (1/0) and minorities (1/0), defined as non-white employees. Given this sample of salaried engineers, women represented 8.0% of the employees and 9.6%of all employees were minorities. Throughout the initial analyses, neither women nor minorities showed any significant differences in pay compression, perceived pay equity, organizational commitment, or intention to turnover.

Individual Performance. Individual performance was measured using the prior year (1999) performance rating provided by the firm. Unfortunately, performance data was only available for 389 of the 481 total survey respondents. Furthermore, the company uses a only a two-category performance rating for (1) average and (2) above average performance which means very little variation exists across the employees sampled. In 1999, 21.6% received the above average rating and 78.4% received the average rating.

RESULTS

Measuring Pay Compression

Descriptive statistics and correlations are presented in Table 1. In order to assess the effects of pay compression on perceived pay equity, organizational commitment and intention to turnover, a relative measure of pay compression was created by regressing years of seniority on salary and saving the residual for each of the 481employees. This residual was then utilized as the measure of pay compression for each subject. The firm uses a broad-banded compensation system based on job grade. Therefore, job grade was controlled for using dummy variables. Regression results are presented in Table 2. The regression of seniority on salary was significant ($F = 464.65$, $p<.001$) and predicted 85.7% of the variance in employee salaries within grade. Compression was negatively correlated (-.28) with seniority indicating that employees experience larger degrees of pay compression as their years with the company increased. The resulting residuals were then used to determine the degree of pay compression. In this case, a positive residual means that an employee is paid higher than what is predicted based on their time with the company. A negative residual means that an employee is "compressed", or paid less than what is predicted by the average return on their years of seniority with the company. Because we are only interested in the present study in determining the impact of pay compression on perceptions of pay equity, affective commitment, and intentions to leave the organization, all subsequent data analysis and hypothesis testing after the computation of the compression factor was conducted only on that portion of the sample which showed to be compressed, i.e. with a residual less than 0. This reduced our sample from 481 total respondents to 229 employees qualifying as currently experiencing pay compression.

Insert Tables 1 & 2 Here

Hypotheses Tests

The effect of pay compression on perceptions of pay equity was tested through hierarchical OLS regression results presented in Table 3. In Step 1, a regression with controls for job grade, education, performance rating, sex, and race predicting pay equity was significant ($F = 2.84$, $p<.01$). Hypothesis 1 was supported in Step 2 in which pay compression was significant ($b = .168$, $p< .05$) and explained 2.1% additional variance ($F = 3.03$, $p<.001$) in perceived pay equity. Results indicate that a standard deviation increase in pay compression is associated with a .17 decrease in perceived pay equity on average. While Hypothesis 1 was supported and pay compression significantly predicted perceived pay equity, it should be noted that only 14.6% of the total variance in pay equity was explained, suggesting wide variations in individual reactions to the relationship between their salaries and years with the company. Also, because the controls for performance rating, sex, and race were all insignificant, these variables were subsequently dropped from the mediation analysis.

Insert Table 3 Here

Hypothesis 2 proposed that pay equity is positively related to organizational commitment. This relationship was supported by a positive and significant coefficient for pay equity ($b = .308$, $p< .001$) in Model 1 in Table 4. The regression, which included controls for job grade and education, was significant ($F = 5.34$, $p< .001$) and explained 15% of the variation in

organizational commitment. Similarly, Hypothesis 4, which predicted that pay equity is negatively related to intention to turnover, was supported by a negative coefficient for pay equity (b = -.273, p< .001) in Model 1 in Table 5.

Hypotheses 3 and 5 which predicted that perceived pay equity mediates the effects of pay compression on organizational commitment and intention to leave were tested using a series of OLS regressions detailed in Tables 4 and 5. Mediation was tested using the procedure detailed by Baron and Kenny (1986). As previously demonstrated in tests for Hypothesis 1, pay compression significantly predicts perceived pay equity. In testing Hypotheses 3, pay compression does not significantly predict organizational commitment, as shown in Model 2 of Table 4. This result indicates that pay compression does not have effects on organizational commitment as mediated by pay equity. Therefore, Hypotheses 3 is not supported.

We tested Hypothesis 5 by examining each step of the proposed mediating relationship (Baron & Kenny, 1986). For the first step, we found support for the relationship between pay compression and pay equity. We then tested the link between pay compression and intentions to turnover. Examination of Model 2 in Table 5 reveals that pay compression does significantly predict intentions to turnover (b = -.173, p< .05). For the final step in the mediational analysis, we entered both pay compression and pay equity as predictors of employee intentions to turnover. Model 3 in Table 5 indicates that when pay equity and pay compression are combined in predicting intentions to turnover, only pay equity remains significant (b =- .253, p< .001), thus providing evidence of a mediating relationship through pay equity and supporting Hypothesis 5.

Insert Tables 4 and 5 Here

DISCUSSION

This study has focused on the impact of pay compression on perceptions of pay equity and individual-level outcome variables. Our results show that pay compression significantly predicts perceptions of pay equity and that pay equity is related to both organizational commitment and intention to turnover. While there is no direct connection between pay compression and employee commitment, compression does directly influence turnover intentions through perceptions of pay equity. In other words, when differences in experience input levels exist (e.g., between newer and existing employees), the resulting pay compression will be viewed as unfair and inequitable and employees will report greater intentions to leave as a result. The present research finds that individuals with greater levels of seniority will view their salary levels as unjustifiably low when compared to individuals with less seniority. Because pay is argued to represent employee value and status (Folger and Cropanzano, 1998; Frank, 1984), longer-tenured individuals who are receiving similar pay rates to newcomers may feel they are being treated inequitably because their experience and demonstrated loyalty are not being rewarded. This relationship between pay compression and pay equity remained significant even after controlling for other factors that have previously been demonstrated to influence perceptions of pay equity such as education and performance (Dreher, 1981). To the best of our knowledge, these findings relating employee perceptions of pay equity directly to pay compression have not been previously demonstrated.

Many previous studies have viewed pay or pay compression as an organizational-level variable in examining organizational-level outcomes (Bloom, 1999; Bloom & Michel, 2002, Lazear, 1989; Shaw et al., 2002). This study shifts the understanding of pay compression from an organizational-level of analysis to the individual-level perspective by determining whether

compression exists for each member of the organization. Such an examination allows us to understand more distinctly the role of personal pay compression on the individual-level outcomes of affective organizational commitment and intentions to turnover. While prior research has explored the effects of pay compression and external labor market forces on the satisfaction levels of university faculty (Brown & Woodbury, 1998; Gomez-Mejia & Balkin, 1987; Pfeffer & Langton, 1993), the current research expands the literature to include individual-level outcomes in a private-sector organization. We believe that our examination of individual-level reactions to pay compression, coupled with a more specific measure of the compression construct, is a significant contribution to the compensation and pay equity literature.

Our results indicate that pay compression can contribute to individual-level outcomes in terms of intentions to leave an organization through the creation of perceptions of inequity. These results indicate the importance of understanding the relationship between pay compression and the retention of experienced human capital. When individuals perceive their compressed pay as unfair, they may seek to alleviate this inequity by looking for opportunities outside the organization. The potential resulting turnover will create significant costs for the organization that could have been avoided through remedies designed to alleviate pay compression.

Implications for Practice

It is important for managers combining macro and micro views of compensation to understand that wide or narrowly dispersed pay systems can each be a strategic option provided gross violations of pay equity do not occur. The beneficial results of limited dispersion in pay systems are likely observed only when individuals possess similar degrees of job experience, talent, seniority, etc. (Shaw et al 2002). Therefore, true pay compression, as defined in this study, would not be expected to exist. In other words, few variations in pay ranges would be

appropriate and beneficial for organizations when individuals possess equal, or at least very similar, input levels. On the other hand, highly dispersed pay systems may foster feelings of inequity and negatively impact employee attitudes and outcomes when there is significant variance in employee inputs (Bloom, 1999). Prior research has shown that as organizational tasks become increasingly interdependent, limited pay differentials become more desirable (Shaw et al., 2002). The key objective for organizations must be to establish a compensation system in which any pay differentials, or lack thereof, are viewed as justifiable by the employees and correspond to the amount of variance in employee inputs. If not, feelings of pay inequity will result.

Furthermore, employers must be cautious in attempts to justify wage rates with the claim that they are only paying what the market demands. To avoid potential negative outcomes, organizations must guard against compression by recognizing and rewarding job experience and demonstrated longevity. Organizations can achieve this objective by raising pay as job experience increases, establishing maximum pay rates for new hires, and continuously evaluating and correcting pay dispersion levels. Guarding against perceptions of inequity, or in other words, actively managing pay equity in organizations, will result in a pay system that motivates employees to achieve maximum personal and organizational outcomes.

Limitations and Suggestions for Future Research

Many limitations exist when conducting research in a field setting and our study is by no means an exception. First, we were faced with the fact that individual pay was described by this organization as formally confidential or secret. Therefore, we cannot know the full extent to which employees understood how their salaries compared to coworkers. However, this lack of knowledge would not necessarily prevent employees from making perceptions regarding their

relative pay. Research has shown that when individuals are unaware of the pay levels of other organizational members they will consistently estimate the salaries of both peers and subordinates (Lawler, 1966; Milkovich & Anderson, 1972) thereby forming inferences concerning their relative worth as compared to a referent other.

Other potential limitations of this study come from the methods used. Common method variance is a concern when examining the effects of pay equity on commitment and intention to turnover because each of these measures were obtained in the same survey administration using self-report Likert scales. Additionally, because only 15% of the variance in perceptions of pay equity is explained by our pay compression model, there are likely unmeasured factors which also contribute to this perception. These factors may include other benefits to seniority, in addition to pay, such as earned vacation time, a vested 401K plan, employee stock options, and other job experience benefits that increase an employee's total compensation and benefit outcomes. Furthermore, individual differences, including personality factors such as levels of equity sensitivity (Sauley & Bedeian, 2000), will likely affect the way in which employees interpret conditions of pay compression.

Next, a limitation to our research is embedded in the type of pay system that exists within the firm. Our data indicated that job grade and seniority in our sample accounted for 85% of the variance in employee salaries, indicating that compression is not widespread within the sample. Compressed individuals within this organization may tend to feel singled out, leading to increased perceptions of inequitable treatment. However, our finding of a significant mediating effect of pay equity, on the relationship between pay compression and intentions to turnover in an organization without widespread compression indicates that these relationships may well be of even greater intensity in an organization where compression is more acute.

Although we feel that our findings make a valuable contribution to the compensation and pay equity literature, many issues remain to be addressed. Future research should focus on the differential comparisons that individuals make when forming pay equity perceptions. Our measure of pay equity included comparisons with both internal and external referents. Based upon a correlation between these two measures of .57, and a reliability coefficient for the combined items of .86, we aggregated these items to represent overall perceptions of pay equity. In the future, researchers should investigate which of these comparisons may be of greater importance in forming pay equity perceptions and how the choice of an employee's referent other may impact associated outcomes.

It is imperative for future research to include individual employee perceptions of their potential success in the external labor market. Adams and Beehr (1998) reported that a person will likely react differently to unfair pay depending upon market conditions. For example, longer tenured employees may perceive that their skill levels are not as current, and possibly even obsolete, when compared to new entrants into the labor pool, who they must compete against for available external positions. If an employee is considering leaving their organization, they will "weigh their current situation against what their situation will be like if they leave" (Adams & Beehr, 1998: p. 647). Consequently, if they perceive that they can improve their current pay situation by utilizing the external labor market, they will be more likely to leave the organization (Hanisch, 1995). Perceived employment opportunities and labor market conditions may thus influence an employee's intention to leave and subsequent turnover (Gerhart, 1990; Hui, 1988).

Future research should also consider the impact of perceptions of pay equity as related to individual and organizational performance. Adams' (1965) theory of inequity predicted that

reactions to negative inequity may include the reduction of employee inputs, which most certainly would involve some level of decreased performance. This reduced effort and performance is an attempt by the employee to achieve an equitable balance. Job performance was not related to pay equity in our study, possibly due to the limited variance of the archival performance measure. However, researchers may want to identify conditions under which pay compression, and resulting perceptions of pay equity, will influence the degree of effort exerted by the employee. Such an understanding would provide further insight into the relationship between fair pay and associated outcomes.

This study has contributed to the compensation and pay equity literature by presenting evidence that compressed pay systems may result in decreased perceptions of pay equity if certain employee inputs are not equivalent. Therefore, future research must shed further light on the situations in which each of the varying forms of pay distribution are most desirable (Bloom, 1999; Shaw et al., 2002). Researchers must continue to build upon these findings to establish an overall framework for choosing between, or expanding upon, our understanding of pay distribution options. Equity theory might well be useful in generating such a framework to determine when individuals will perceive their pay as fair. The key consideration when evaluating the effectiveness of a compensation system may not simply be in considering the degree of pay dispersion, but how that level of dispersion corresponds to the level of inputs the employee provides the organization. As a result, the effective pay system becomes one in which employee perceptions of pay fairness are maximized and the degree of variance in employee input levels is a key factor in predicting individual-level reactions to pay decisions.

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Table 1

Descriptive Statistics and Correlations

	N	Mean	s.d.	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.	13.	14.	15.	16.
1. Salary (000's)	244	61.35	14.65	1.00															
2. Seniority (years)	244	11.30	10.74	.63	1.00														
3. Pay Compression	244	-5.04	4.16	-.24	-.28	1.00													
4. Perceived Pay Equity	230	2.94	0.89	-.04	-.17	.15	1.00												
5. Organizational Commitment	238	3.25	0.73	-.09	-.13	.12	.31	1.00											
6. Intention to Turnover	242	2.65	1.20	-.04	-.06	-.13	-.27	-.50	1.00										
7. Grade 1	244	0.00	0.00	.00	.00	.00	.00	.00	.00	1.00									
8. Grade 2	244	0.13	0.34	-.43	-.36	.21	.24	.07	-.01	.000	1.00								
9. Grade 3	244	0.20	0.40	-.49	-.33	.24	.01	.14	-.09	.000	-.20	1.00							
10. Grade 4	244	0.18	0.38	-.18	-.06	.18	-.12	.03	.06	.000	-.18	-.24	1.00						
11. Grade 5	244	0.35	0.48	.35	.39	-.27	-.14	-.24	.04	.000	-.28	-.37	-.34	1.00					
12. Grade 6	244	0.10	0.30	.44	.21	-.22	.07	.04	.07	.000	-.13	-.17	-.15	-.24	1.00				
13. Education	243	4.81	1.02	.32	-.06	-.09	-.16	-.04	.15	.000	-.18	-.13	-.01	.01	.20	1.00			
14. Performance Appraisal	203	2.22	0.42	.28	.04	-.16	.05	-.02	-.02	.000	-.14	-.19	-.06	.10	.17	.19	1.00		
15. Minority	244	0.10	0.30	-.21	-.15	.07	.01	.12	-.03	.000	-.01	.16	.13	-.13	-.11	-.05	-.10	1.00	
16. Female	244	0.11	0.32	-.18	-.19	.09	.04	.04	-.01	.000	.17	.07	.00	-.13	-.03	.00	-.07	.46	1.00

Note: Correlations of .125 or greater are significant at $p < .05$

Table 2

Regression of Seniority on Employee Salary

	Salary Beta[a]	*t*
Organizational Tenure	.24	6.58***
Grade 1	-23.09	-18.21***
Grade 2	-21.48	-21.31***
Grade 3	-13.94	-14.22***
Grade 4	13.64	12.71***
Grade 5	34.32	22.45***
R^2 (adjusted R^2)		.86 (.86)
F		464.65***
Df		465
N		471

[a]*unstandardized*

* $P < .05$

** $P < .01$

*** $P < .001$

Table 3

Regression of Pay Compression on Perceived Pay Equity

	Pay Equity Step 1 Beta[a]	*t*	Step 2 Beta[a]	*t*
Grade 1	0.24	3.21**	0.20	2.51*
Grade 2	0.11	1.39	0.05	0.54
Grade 3	-0.05	-0.59	-0.10	-1.18
Grade 4	0.17	2.25*	0.20	2.54*
Grade 5	0.13	1.71	0.15	1.96*
Education	-0.20	-2.61**	-0.21	-2.80**
Performance	0.08	1.09	0.08	1.13
Sex	0.01	0.07	0.01	0.07
Race	-0.02	0.24	0.03	0.43
Pay Compression			0.17	2.06*
R^2 (adjusted R^2)		.13 (.08)		.15 (.10)
F		2.84**		3.03***
ΔR^2				.02
ΔF				4.26*
Df		179		178
N		188		188

[a]*standardized*

* $P < .05$

** $P < .01$

*** $P < .001$

Table 4

Mediation Analyses for Pay Compression and Organizational Commitment

	Organizational Commitment Model 1		Organizational Commitment Model 2		Organizational Commitment Model 3	
	Beta[a]	*t*	Beta[a]	*t*	Beta[a]	*t*
Grade 1	0.08	1.08	0.15	2.00*	0.07	0.10
Grade 2	0.23	3.19**	0.23	2.94**	0.22	2.93**
Grade 3	0.17	2.39*	0.14	1.85	0.16	2.23*
Grade 4	0.10	1.49	0.15	2.16*	0.10	1.48
Grade 5	0.07	1.08	0.13	1.89	0.07	1.09
Education	0.02	0.23	-0.05	-0.67	0.02	0.22
Pay Equity	0.31	4.63***			0.31	4.54***
Pay Compression			0.06	0.87	0.01	0.12
R^2 (adjusted R^2)		.15(.12)		.07(.04)		.15(.12)
F		5.34***		2.41*		4.65***
Df		218		229		217
N		225		236		225

[a]*standardized*

* $P < .05$

** $P < .01$

*** $P < .001$

Table 5

Mediation Analyses for Pay Compression and Intention to Turnover

	Intention to Turnover Model 1		Intention to Turnover Model 2		Intention to Turnover Model 3	
	Beta[a]	*t*	Beta[a]	*t*	Beta[a]	*t*
Grade 1	0.08	1.10	0.06	0.77	0.12	1.56
Grade 2	-0.06	-0.86	-0.02	-0.22	-0.02	-0.19
Grade 3	0.04	0.49	0.08	1.12	0.07	1.00
Grade 4	0.07	1.06	0.00	0.03	0.05	0.75
Grade 5	-0.11	-1.58	-0.19	-2.80 **	-0.13	-1.83
Education	0.10	1.42	0.19	2.74 **	0.11	1.62
Pay Equity	-0.27	-4.07 ***			-0.25	-3.75 ***
Pay Compression			-0.17	-2.39 *	-0.13	-1.77
R^2 (adjusted R^2)		0.11 (0.08)		0.08 (0.05)		0.13 (0.09)
F		4.00 ***		2.89		3.92 ***
Df		221		233		220
N		228		240		228

[a]*standardized*

* $P < .05$

** $P < .01$

*** $P < .001$

FIGURE 1

Impact of Pay Compression on Perceptions of Pay Equity and Individual Employee Factors