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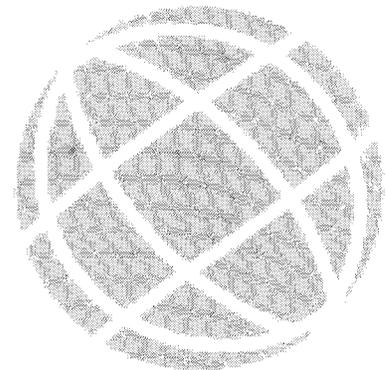
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WORKING PAPER SERIES

Employee Compensation: Research and Practice

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Working Paper 92-26



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In M.D. Dunnette & L.M. Hough (Eds.), Handbook of Industrial & Organizational Psychology, 2nd Edition, Palo Alto, CA: Consulting Psychologists Press, Inc. (forthcoming)

This paper has not undergone formal review or approval of the faculty of the ILR School. It is intended to make results of Center Research, conferences, and projects available to others interested in human resource management in preliminary form to encourage discussion and suggestions.

INTRODUCTION

An organization has the potential to remain viable only so long as its members choose to participate and engage in necessary role behaviors (March & Simon, 1958; Katz & Kahn, 1966). To elicit these contributions, an organization must provide inducements that are of value to its members. This exchange or transaction process is at the core of the employment relationship and can be viewed as a type of contract, explicit or implicit, that imposes reciprocal obligations on the parties (Barnard, 1936; Simon, 1951; Williamson, 1975; Rousseau, 1990). At the heart of that exchange are decisions by employers and employees regarding compensation.

From the organization's perspective, perhaps no other set of decisions are as visible or as consequential for the success or failure of an organization. From a cost perspective alone, effective management of employee compensation is critical, given that it often represents the single largest cost incurred by an organization, typically accounting for 10-50% of total operating costs, and as much as 90% of such costs in some labor-intensive (e.g., service) organizations.

Of course, cost is only one part of the picture. It is also necessary to evaluate the employee contributions the organization receives in exchange. Thus, a second reason for studying compensation from the organization's perspective is to assess its impact on a wide range of employee attitudes and behaviors, and ultimately, the effectiveness of the organization and its units. Compensation may directly influence key outcomes like job satisfaction, attraction, retention, performance, flexibility, cooperation, skill acquisition and so forth. However, its influence may also be indirect by facilitating or constraining the effectiveness of other human resource activities (e.g., recruiting, selection, training,

development). In either case, its significant costs and its potential for significant effects on attitudes, behaviors, and ultimately organization effectiveness suggest that compensation is an area of strategic importance.¹

To the individual employee, compensation decisions also have important consequences. Salaries and wages represent the main sources of income for most people, and may also be taken as key indicators of a person's social standing or success in life. Benefits, such as health care and pensions, are also important determinants of well being and financial security among employees and their dependents. Not surprisingly then, employees have sought to influence such decisions in a variety of ways, including through unions, supporting government regulation of compensation decisions, and through the courts. Therefore, it is important to understand how individuals are affected by (and react to) different compensation decisions.

In this chapter, our goal is to define and describe the major decisions that organizations make in managing employee compensation and, based on theory, research, and practice, evaluate what the outcomes of such decisions are likely to be under different conditions. We have made several specific decisions in focusing the review.

First, compensation, like staffing, recruitment, and training, is an applied area of study where issues tend to be defined in terms of understanding the effectiveness and equity of actual decisions in organizations. Thus, although both parties to the employment exchange are of interest, we focus most of our attention on employer decisions. Our discussion of employee decisions is mostly limited to cases where a better understanding carries potential implications for organizational practice. (For example, understanding what determines individuals' pay satisfaction may help improve the design of compensation programs.)

Second, given its applied nature, our focus is truly on compensation itself, rather than compensation as a means of testing particular psychological theories of motivation (see Dyer & Schwab, 1982 on this point). In this sense, our chapter differs from the work motivation chapters in the first (Campbell & Pritchard, 1976) and second (Kanfer, 1991) editions of the Handbook, and is more similar to the reward systems part of Lawler's (1976) chapter on control systems in the first edition. Although much of our orientation is, of course, psychological, compensation is an area of great interest to other disciplines as well. Thus, we also draw freely on the economics, sociology, and finance literatures at various points.

Third, our focus on managerial implications has also led us to devote relatively little attention in this chapter to what may be termed more tactical questions (e.g., the choice between job evaluation or performance appraisal instruments; see Gomez-Mejia & Welbourne, 1988; Milkovich, 1988) or to determinants of compensation (see Gerhart & Milkovich, 1990 for a review). Our main focus in discussing determinants is the relative importance of organization differences in compensation decisions.

Fourth, we have, for the most part, chosen to limit our attention to pecuniary (i.e., monetary) aspects of employee compensation. Obviously, there is good reason to believe that many other attributes of jobs (e.g., challenge, significance, prestige, supervision, working conditions, coworkers, etc.) can also have important effects on employee attitudes and behaviors. But, reviewing this literature would greatly expand an already large task. We do not believe that our conclusions regarding pay decisions will be invalidated by this omission, at least not to any greater extent than other obvious omissions (e.g., examining compensation in relative isolation from other intertwined issues like staffing, training). We do, however, discuss the role of pay vis-a-vis other rewards and other employment

activities later in the chapter.

As Figure 1 indicates, we have classified compensation (or pay) decisions into four broad categories that the compensation literature (e.g., Belcher & Atchison, 1987; Heneman & Schwab, 1985; Heneman, 1985; Milkovich & Newman, 1990) suggests as most important: pay level, structures, individual differences in pay, and benefits. (A potential fifth category, administration, is addressed within each of the four decision areas.) We suggest that decisions in these areas influence individual and group outcomes which, in turn, influence unit (e.g., plant, business unit) outcomes, and ultimately, organization outcomes. Contingency factors are also included in the model in recognition of the fact that the relation between pay decisions and outcome variables may depend on a host of organization, job, individual, and external factors.

The chapter is organized around the four compensation decision areas shown in Figure 1. Within each decision area, we structure our discussion around the following areas: definition and properties, determinants, consequences, and suggested research directions. Our discussion of contingency factors also takes place within each of the four compensation decision area sections, although in a less structured manner. Finally, our review includes four special topics: pay vis-a-vis non-pay rewards, discrimination, executive pay, and international comparisons. We now turn to pay level, the first decision area shown in Figure 1.

PAY LEVEL

Definition and Properties

Compensation includes any direct or indirect payments to employees, such as wages, bonuses, stock, and benefits. Ehrenberg and Milkovich (1987) have defined pay level as the "average compensation paid by a firm relative to that paid by its competitors" (p. 89).

This definition suggests several implications. First, pay level refers to a characteristic of the organization (e.g., Heneman & Schwab, 1979; Mahoney, 1979). Second, pay level is an attribute that is defined relative to product and labor market competitors. Therefore, pay level research will ordinarily require data on multiple organizations. Third, conclusions regarding relative pay level will depend heavily on how these competing organizations are defined and chosen. Although perhaps not as explicit in the definition, we would add a fourth point, namely, that measuring total compensation goes beyond a consideration of wages and salaries.

Direct pay now represents approximately 72% of total compensation costs, with benefits accounting for the remaining 28% (Nathan, 1987; U.S. Chamber of Commerce, 1991). Thus, it is less and less correct to equate direct pay with total monetary compensation. Yet, there is no single correct way to assess the relative contributions of pay and benefits to total compensation, a particularly relevant issue given what appears to be the increasingly significant differences in benefits packages offered by different organizations.

One way to define relative contribution is in terms of cost to the employer. However, it would be a mistake to equate employer cost with value to the employee, which might be quite different. For example, the type of health coverage that employees select under flexible benefit plans varies more with demographics (e.g., age, sex) than with the dollar cost to employees, suggesting that employees differ in the value attached to different coverage options (Barringer, Milkovich & Mitchell, 1991). Similarly, the fact that some organizations (e.g., Bank of America) have eliminated retiree health care coverage for all new hires suggests that organizations believe that different groups of employees (in this example, new hires) may differ in the value attached to particular aspects of compensation.

Yet, there is little or no research to answer the question of how much value different employee groups attach to different aspects of pay.

The fact that value to employee may differ from cost to employer suggests that, in some cases, less costly total compensation packages may actually provide total inducements that are of greater value to employees than those associated with more costly packages. For example, although a package including many costly benefit options might be the most costly, its value to employees might fall short of the value attached to a less costly package of benefits that is better tailored to employee needs or values. Therefore, measurement of own and competitors' pay levels would ideally include the value to employees of different elements of total compensation.

Even limiting the focus to direct pay does not eliminate measurement difficulties. For example, the use of variable pay causes further measurement complexities because pay level can be assessed accurately only in retrospect. To illustrate, although total compensation cost can be reasonably estimated if there is an average wage of \$10/hour with average annual increases projected (or specified in a contract) at 6% for each of the following 2 years, this is not the case if the average hourly wage is \$9.50 with a chance to make anywhere from \$0 to \$5 per hour per year more, depending on profits or stock performance. In the past, this issue arose mostly in the context of executive stock options. However, stock options and other types of variable pay are now being expanded to other employee groups.

Unfortunately, most pay level research has focused solely on base salary. Yet, surveys suggest that base pay is coming to represent a smaller portion of direct pay (O'Dell, 1987; Bureau of National Affairs, 1988). Only a few studies, often in the area of executive compensation, have also included other components of direct pay (e.g., bonuses),

but mostly in the context of studying determinants of compensation. Virtually no research has examined the role of total compensation in comparisons of organization success in achieving cost and behavioral objectives.

In setting pay levels, an organization is largely interested in productivity or unit labor cost--the cost to produce a given unit of output. Thus, two organizations with identical pay and benefits may have very different total or unit labor costs because staffing levels are higher in one than the other. Further, even if overall staffing levels were equal, the mix of skills or jobs could differ significantly, thereby providing another source of cost differences. Yet, unit labor cost is rarely used when comparing (benchmarking) against the competition and setting one's own pay level.

Determinants of Pay Level

Consistent with our pay level definition, our focus in this section is on organization differences in pay levels.

Benchmarking Against the Competition and Relative Pay

Pay levels of labor market and product market competitors play an important role in determining pay level. Mahoney (1979) (see also Dunlop, 1957), argues that product market (industry) competition places an upper bound on pay level because organizations in a particular industry "encounter similar constraints of technology, raw materials, product demand, and pricing" (p. 122). Thus, an organization will find itself at a competitive disadvantage in the product market if its labor costs exceed those of its competitors because such costs will ordinarily be reflected to some extent in higher prices for its products. For example, if Ford has higher labor costs than Toyota, Ford will have difficulty in providing the same quality automobile at a competitive price. Consequently, product market pressures may act as an upper bound on employee compensation. (See

Krueger & Summers, 1986, 1988 for a review of product market effects on pay.)

However, organizations do not compete solely in the product market. They also compete in the market for labor. Ford, for example, competes for engineers, lawyers, and human resource managers not only with other automotive companies, but also with companies in the computer, aerospace, electronics, and other industries. A pay level that is too low relative to these competitors could lead to difficulties in attracting and retaining sufficient numbers of quality employees. As such, labor market competition can be seen as placing a lower bound or floor on pay level (Milkovich & Newman, 1990). The classical economics literature suggests that, taken together, product market and labor market competition may provide relatively little discretion on the part of employers in choosing a pay level (Gerhart & Milkovich, 1990).

Organizations attempt to gather information about pay practices of competitors through the use of pay surveys (see Fay, 1989). However, finding the "going rate" of pay may be easier in theory than in practice. As Rynes and Milkovich (1986) point out, administrative decisions are required about a range of issues including: (a) which employers are included? (b) which jobs are included? (c) which jobs are considered similar enough to use in benchmarking? (d) if multiple surveys are used (fairly typical), how are the multiple rates of pay weighted and combined? Practice in these areas seems to vary across (and probably within) employers.

The choice of employers is probably one of the most important decisions. It goes to the heart of the organization's competitive business strategy and its likely success in attracting and retaining employees who may or may not define their alternative employment opportunities in the same manner. The organization must decide (a) which employers are its key competitors in both its labor and product markets, and (b) whether to give more

weight to either the product or labor market.

In considering the latter decision, there are probably several factors that argue in favor of emphasizing one or the other. For example, product market comparisons (i.e., a focus on labor costs) are likely to deserve greater weight when (a) labor costs represent a large share of total costs, (b) product demand is elastic (i.e., product demand changes in response to product price changes),² (c) the supply of labor is inelastic, and (d) employee skills are specific to the product market (and will remain so).³ In contrast, labor market comparisons may be more important to the extent that (a) attracting and retaining qualified employees is difficult, and (b) the costs (administrative, disruption, etc.) of recruiting replacements are high.

As the importance of a particular comparison increases, so too should the resources devoted to information and measurement. For example, if product market comparisons are critical, more resources need to be devoted to measuring compensation (or better, unit labor costs) paid by such organizations. In contrast, if labor market comparisons are important, it is necessary to devote resources to find out to which organizations applicants and employees are being lost.

To what extent do employers actually engage in these information collecting and monitoring activities? We do not have any direct evidence, but data on a related issue (recruiting) seems to indicate that organizations in the Fortune 1000 devote few resources to evaluating recruiting activities (Rynes & Boudreau, 1986). Considering that compensation and recruitment often fall in different administrative parts of the human resource function, it is perhaps even less likely that organizations devote much attention to monitoring the influence of compensation decisions (e.g., emphasizing product market versus labor market comparisons) on recruiting success outcomes such as applicant

attraction.

Although the validity of conclusions reached through the survey process may depend critically on how the competition is defined (i.e., what organizations are chosen for inclusion), little evidence exists on how such choices are made or their implications. Rather, most attention has been focused on potential problems in the job evaluation process, especially in the context of pay equity or comparable worth discussions. Nevertheless, as Schwab (1980) has pointed out, job evaluation is usually "validated" against some measure of the market rate, meaning that the measure of the latter is critical. As Rynes and Milkovich (1986) note, although paying the going rate has been an effective employer defense in pay equity cases where female-dominated jobs are underpaid relative to their job evaluation points, the Courts have not really scrutinized whether the measure of the going rate is itself obtained in a valid fashion.

Preliminary evidence on the validity of employer estimates of going rates from the Gerhart and Milkovich (1990) study is not encouraging. One question in the survey asked "How do you define your target pay level?" (below the median, at the median, between the median and the 75th percentile, at the 75th percentile, above the 75th percentile). The correlation between these responses and actual relative pay level (adjusted for differences in employee, job, and organizational factors) was .50, suggesting some convergent validity, but also a fair amount of unexplained variance in the self-reports. An additional analysis (not reported in the 1990 study) further indicated that none of the 124 organizations reported that they were below the median. Aside from Lake Wobegon (of central Minnesota fame), we know of no population where the laws of statistics permit everyone to be at or above the median. Therefore, this finding again raises the question of how valid assessments of going market rates are likely to be.

Are There Significant Employer Differences in Pay Level?

Before examining the consequences of organizational differences in pay level, it is perhaps necessary to first establish that significant organization effects on pay exist. There is not a consensus on this issue.

Much of the theory and evidence on this point comes from the economics literature. Standard economic theories of competitive markets (e.g., human capital theory, Becker, 1975; compensating wage differentials theory, Smith, 1937) tend to view employers as price-takers, meaning that they must pay the "going rate" if they are to be competitive. If they pay less, they will not be able to attract a sufficient number of qualified employees. If they pay more, their higher costs will drive them out of business. Adam Smith (1937) suggested that the net utility of all jobs was equal when compensating factors such as working conditions, training required, and so forth were factored in. Thus, for example, apparently similar jobs in different organizations may be paid differently because non-compensation job attributes differ between the two jobs. To attract and retain people in jobs having more unfavorable non-compensation attributes, a compensating differential (i.e., higher pay) is required. This view suggests that after accounting for differences in product and labor market competition, the mix of jobs, non-pecuniary job attributes, and the nature of the workforce, organization pay levels will not differ to any significant degree. There is a lively debate regarding the validity of this model, partly because it is so difficult to test (see Brown, 1980; Ehrenberg & Smith, 1988). Specifically, a strong test requires the control of all job attributes and worker ability, which is obviously a difficult task, akin to the problems encountered in the pay discrimination literature.

Empirical evidence on the importance of organization effects on pay level is mixed. Based on data from one industry (California electronics firms), Leonard (1988) concluded

that "firms that deviate from the average (market) wage, tend to return towards the market wage" (p. 28). In other words, organization differences in pay level were found to be insignificant. In contrast, building on the work of Dunlop (1957) and others, Groshen (1988) found that organization differences in pay level were of a significant magnitude and highly stable over time, suggesting that competitive markets do not completely determine pay, leaving open the possibility that employers may engage in different pay level strategies.

Both the Leonard (1988) and Groshen (1988) studies, however, have limitations. First, neither study controlled for employee characteristics, leaving open the possibility that organization pay level differences (e.g., in the Groshen study) were a result of different levels of human capital. Second, both studies focused largely on lower level occupations (mostly blue-collar and nonsupervisory white-collar). Third, Leonard's (1988) results were obtained on a single industry (California electronics organizations), which was composed mainly of small employers operating in intensely competitive product and labor markets. This level of competition may exceed that found in much of the rest of the economy, perhaps helping explain the lack of stable employer differences in his study.

Other studies, not subject to these limitations, suggest that there are stable organization differences in pay over time. For example, Gerhart and Milkovich (1990) used the Cornell Center for Advanced Human Resource Studies (CAHRS) compensation data base to examine this issue. The sample was composed of roughly 16,000 middle and top level managers from 200 organizations followed over a period of up to five years. Extensive controls for organization differences in human capital, job level, and organization characteristics were included. They found, consistent with Groshen (1988) that there were significant and stable employer differences in pay level over the five year period.

Similarly, Weber and Rynes (1991) found significant pay level strategy differences between organizations. Significant employer differences in pay strategy may indeed exist.

Consequences of Employer Pay Level Differences

Theoretical Explanations

The research by Groshen (1988) and Gerhart and Milkovich (1990) suggests that similar employers make different pay level decisions. Why is this the case? The answer to this question is important because it serves as a starting point for our examination of the possible cost and behavioral consequences of different pay level strategies. Although the psychological literature (e.g., expectancy and equity theories) suggest ways in which pay level may influence individual employees or applicants, it does not directly address the question of why organizations engage in different compensation practices. Thus, we look to the economics (efficiency wage models) and strategy literatures.

Efficiency Wages. The basic idea behind efficiency wages is that organizations setting pay higher than their competitors can realize increased efficiency. Four different variants (sorting, shirking, turnover, gift exchange) of the model focus on different mechanisms by which this can happen (see Groshen, 1988).

Sorting by Ability (or Adverse Selection). Some employers may pay higher rates of pay as a means of hiring and retaining higher ability employees. (Empirical evidence on pay level and recruiting is reviewed below.) Even if one accepts the implied assumption of valid selection systems, the following question arises: What advantage is there to having higher ability employees if their higher pay offsets their higher productivity? One answer is that some organizations have a technology or work design that is more sensitive to ability than that of their competitors and therefore, receive a greater productivity return from higher employee ability levels. As one example, Japanese automobile plants in the

U.S. tend to engage in much more intensive screening of job applicants than do U.S. employers. One reason may be that the Japanese companies are more likely to have to live with hiring mistakes because of their emphasis on employment security. However, an additional reason may be that their greater use of self-directed work teams requires more able employees.

Shirking/monitoring and turnover. These two formally identical variants (Yellen, 1984) suggest that worker productivity is often difficult to measure, permitting workers (in the now popular parlance of economists) to "shirk" (i.e., screw around). These models suggest that one way to discourage shirking is to set the pay level above that the worker can obtain elsewhere. The expected effect is that the worker will be less likely to shirk because s/he does not wish to risk losing this premium wage. The alternative, by definition, is a lower paying job (i.e., with a non-efficiency wage employer) or, if all firms raise wages, the alternative is unemployment (Yellen, 1984). In this sense, "unemployment plays a socially valuable role in creating work incentives" (Yellen, 1984).⁴

Gift exchange/sociological morale. In contrast to the other efficiency wage models, this variant has less of neoclassical economics orientation, focusing more on social conventions (Yellen, 1984). Akerlof (1984), in describing his "partial gift exchange" model, suggests that "some firms willingly pay workers in excess of the market-clearing wage; in return they expect workers to supply more effort" (p. 79, 1984). Or, as Yellen describes it, firms pay "workers a gift of wages in excess of the minimum required, in return for their gift of effort above the minimum required" (p. 204). Akerlof cites Adams (1965) work on overreward inequity as empirical support. He also notes, however, that "not all studies reproduce the result that 'overpaid' workers will produce more" (p. 82).

These efficiency wage models are open to a number of criticisms. For example,

there is the following paradox. If higher pay is used to discourage shirking where monitoring is most difficult, how is it possible to monitor well enough to determine when a worker is shirking enough to terminate him or her? The gift exchange variant assumes that overreward equity is a compelling force for increasing worker effort and productivity, yet research shows that overreward equity is very difficult to obtain and maintain, especially outside of the laboratory. (See Campbell & Pritchard, 1976; Kanfer, 1991 for reviews.)

Strategy. A common theme in the compensation management literature is that organizations have considerable discretion in the design of pay policies (Broderick, 1985; Carroll, 1987; Foulkes, 1980; Gomez-Mejia & Welbourne, 1988; Lawler, 1981; Milkovich, 1988). As such, even similar organizations may follow different compensation practices. In this sense, the strategy perspective differs from efficiency wage models which sometimes seem to assume that whatever compensation system an employer uses must be efficient and is the one best system given its particular characteristics. It also differs from institutional (and population ecology) approaches, which lean toward environmental determinism (i.e., practices are dictated by the organization's environment). In contrast, the strategy perspective suggests that even similar organizations may follow different strategies, some of which may be more efficient than others.

Strategy can be measured using intentions, actions, or both. A focus on actions (actual compensation policy decisions) may be advisable given that the correspondence between intentions and actions is not necessarily high (Mintzberg, 1978, 1987; Snow & Hambrick, 1980). In compensation, actions, rather than intentions or plans, are likely to have the greater consequences for costs and employee behaviors. Thus, consistent with business strategy measurement approaches that focus on the content outcome of the strategy

process (e.g., Hofer & Schendel, 1978; Chrisman, Hofer, & Boulton, 1988), "realized" pay strategies describe cases where "a sequence of decisions in some area exhibits consistency over time" (Mintzberg, 1978, p. 935; see also Miles & Snow, 1978). In other words, for organization effects to have strategic properties, they should be stable over time.

The Gerhart and Milkovich (1990) study provides an example of the use of realized compensation strategies. As noted earlier, they did find evidence of significant organization differences in pay level decisions. Therefore, the emphasis on organization differences in compensation decisions found in the efficiency wage and strategy literatures has some empirical support. This, in turn, suggests a need to examine the consequences of these organization differences.

Evidence on Specific Pay Level Consequences

In terms of behavioral outcomes of pay decisions, relative pay level has been typically viewed as having its main impact on attraction and retention, whereas individual differences in pay are often seen as more relevant to performance within the organization. However, these distinctions are becoming less accepted. For example, some of the efficiency wage models reviewed above clearly view pay level as a determinant of effort. In addition, the way individuals are paid may have consequences for the types of individuals attracted and retained. Below, we focus on empirical evidence regarding pay level effects.⁵

Attraction. There is ample evidence that pay level can increase the size of the applicant pool, likelihood of job acceptance, and the quality of job applicants. For example, Krueger (1988) found that both the application rate and applicant quality increased for government jobs as the ratio of government to private sector wages increased. Similarly, Holzer (1990) found that higher wages reduced vacancy rates, increased the

perceived ease of hiring, and resulted in less time spent on informal training (see also Barron, Bishop & Dunkelberg, 1985). Other studies reviewed by Rynes and Barber (1990), including studies of military recruitment, point to similar conclusions.⁶ In addition to recruiting effects, there is also evidence that high wage organizations have better quality employees in general (Brown & Medoff, 1989).

A very closely related question, How does pay level influence job choice decisions in attracting new employees?, has also been examined. As Rynes, Schwab, and Heneman (1983) pointed out, institutionally-oriented economists like Reynolds (1951) argued many years ago that pay entered into decisions in a noncompensatory fashion. That is, applicants were believed to have a reservation wage below which they would not accept a job offer regardless of how attractive it was on other dimensions. Rynes et al. provided empirical support that this hypothesis is indeed accurate under certain conditions, further supporting the idea that pay level is often critical in attraction. The key limiting condition was the degree of variance in pay across organizations competing for the applicants. Applicant decisions became less compensatory as the market variance in pay increased. Simply stated, the greater the variability in pay offers, the more important was pay level.

Similarly, the importance of pay level is also emphasized in Barber's (1990) work on pay as a signal of other attributes. Building on Spence's (1973) work, she found that in the absence of complete and accurate information, applicants may make inferences about non-pecuniary job attributes based on what they know about its relative pay level. These types of inferences increase in importance if one accepts the description of job seekers as typically knowing little about potential jobs (prior to actually being employed) other than the rate of pay and the general type of work (e.g., Reynolds, 1951). This lack of information is likely to be a matter of degree of course, with applicants for exempt

positions often having the opportunity to gather information on other job attributes through plant visits and other means. Nevertheless, pay is always one of the more visible and probably one of the more important attributes in such decisions. Even in cases where pay appears less important, the explanation may be that there is simply little variation among employers in pay level, thus taking it out as a factor in decisions (Rynes et al., 1983). This may, however, simply attest to the fact that pay level is so important that organizations monitor it closely so as not to get out of line one way or another (Gerhart & Milkovich, 1990).

In summary, although it is true that pay level is only one attribute among many that determine whether an organization is viewed by applicants as being an "employer of choice" (Milkovich & Newman, 1990, p. 198), evidence suggests that it may be a critical attribute in many cases. Considerable research remains to be done on the signals that pay level sends to applicants (and perhaps current employees).

Pay Satisfaction. Psychological theories typically specify that pay influences behaviors through its effect on perceptions and attitudes. One key attitude that is hypothesized to be related to behaviors such as turnover, absenteeism, and union activity (Heneman, 1985) is pay satisfaction. It is hypothesized to be a function of the discrepancy between perceived pay level and what an employee believes the pay level should be (Locke, 1976; Lawler, 1971; Heneman, 1985). Empirical evidence supports this discrepancy model (Dyer & Theriault, 1976; Rice, Phillips & McFarlin, 1990). Frame of reference (Smith, Kendall & Hulin, 1969) and social comparison approaches (e.g., equity theory, Adams, 1963) fit well with the discrepancy model,⁷ offering explanations for how the "should be" component of pay satisfaction is determined.⁸

Heneman (1985) has suggested two modifications to the discrepancy model. First,

rather than treating pay as unidimensional, pay can be classified into level, structure, system, and form categories (Heneman & Schwab 1979). (These categories parallel our level, structures, individual differences in pay, and benefits decision areas.) Second, building upon Dyer and Theriault's (1976) work, Heneman suggested that the model include an additional variable, employee feelings about pay policies and administration.

Dyer and Theriault's (1976) research provided an early indication of the potential importance of procedural justice, in addition to distributive justice, in compensation. Subsequent work by Greenberg (1986) supports the independence of procedural justice. Further, Folger and Konovsky (1989) found that procedural justice explained variance in pay raise satisfaction beyond that accounted for by the actual pay raise and distributive justice perceptions. Although this particular increment was not large, procedural justice perceptions also explained variance in organizational commitment and trust in supervisor, suggesting that its influence on broader organization attitudes may be greater.

Given a multidimensional definition, the Pay Satisfaction Questionnaire (PSQ, Heneman & Schwab, 1983) was developed to measure satisfaction with four facets of pay satisfaction: level, benefits, raises (referred to earlier as "system"), and structure/administration. Although as discussed above, structure and administration were viewed as conceptually distinct dimensions, the items designed to measure the two facets clustered together empirically. Heneman and Schwab (1985) provide support for the construct validity of the PSQ. They also note that existing unidimensional pay satisfaction measures (e.g., the pay subscales of the Job Descriptive Index and the Minnesota Satisfaction Questionnaire) are largely measures of pay level (see also Scarpello, Huber & Vandenberg, 1988).

Subsequent research has also been generally supportive of the PSQ's construct

