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ROOT

OF THE

PROBLEM

Weeding Out Pay Inequities

BY TAKIS MAKRIDIS, JOSH SCHAEFFER, PH.D., THERESE SEBASTIAN AND SASWATI SEN

THE ROOT OF THE PROBLEM

By now, most organizations have performed some type of pay equity assessment. That's left many grappling with how to use the analysis results to improve the pay structure — and the business along with it. Numerous questions abound, such as:

- Should all employees paid below their expected pay range be adjusted?
- Should males and non-minorities flagged as having below-expected pay be adjusted, or only women and minorities with below-expected pay?
- Should we increase the pay for all or a large portion of women and/or minorities, or only for those with severe discrepancies?
- Should the messaging reference the occurrence of a pay equity study?
- What were the root causes that led to the situation and how can they be addressed?
- What non-pay-related programs would help drive sustainable improvement?

In our experience, organizations address the pay gaps they discover by taking a mix of short-term corrective actions and long-term initiatives. We'll go over the different remediation strategies we see in practice, including their pros and cons. Before we do that, though, let's review what goes on in a typical pay equity study.

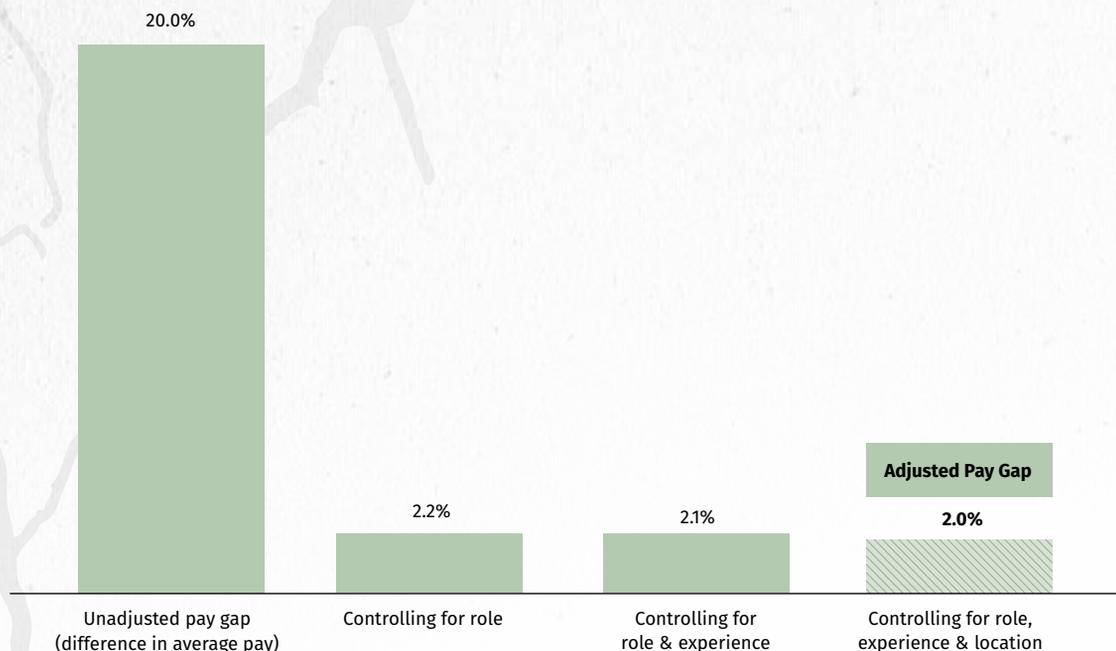
How a Pay Equity Study Works

A state-of-the-art pay equity study uses a multi-variate statistical regression model to analyze the relationship between pay and variables assumed to influence pay. Legitimate criteria like role, experience, performance and location should explain any variation in pay across an employee base.

But, this is not always the case. The regression modeling will test whether, after controlling for these legitimate criteria, the remaining portion of the pay differences are statistically linked to gender or race and, if so, to what extent. This yields the pay gap statistic, which is usually expressed as women (or minorities) earning X cents on every dollar of male

Figure 1

The statistical model controls for legitimate factors of pay by layering each factor on top of the other until there are no longer any factors that are statistically significant. For company A, the statistically significant factors predicting pay are role, experience and location. After incorporating these variables, the adjusted pay gap is 2%.



Source: Equity Methods

(or non-minority) compensation. Figure 1 provides an example on how this plays out for Company A.

As part of the process, the model provides an expected pay amount for each employee, along with a margin of error. From this, we can generate a list of employees whose actual pay falls outside of this predicted range. For most employees, the difference between expected and actual pay might not be statistically significant; employees that do have statistically significant pay gaps are what we call “outliers.”

Looking Past the Outliers

It’s natural to immediately jump to the outliers, propose pay adjustments, and claim victory since they’re the group with the largest expected-to-actual pay disconnects. But wait, not so fast. The outliers could just be the tip of the iceberg of more structural pay equity issues that cut across a larger group of employees. To find out if that is the case, we begin by analyzing the pay distributions of men and women — as well as minorities and non-minorities — across the whole organization.

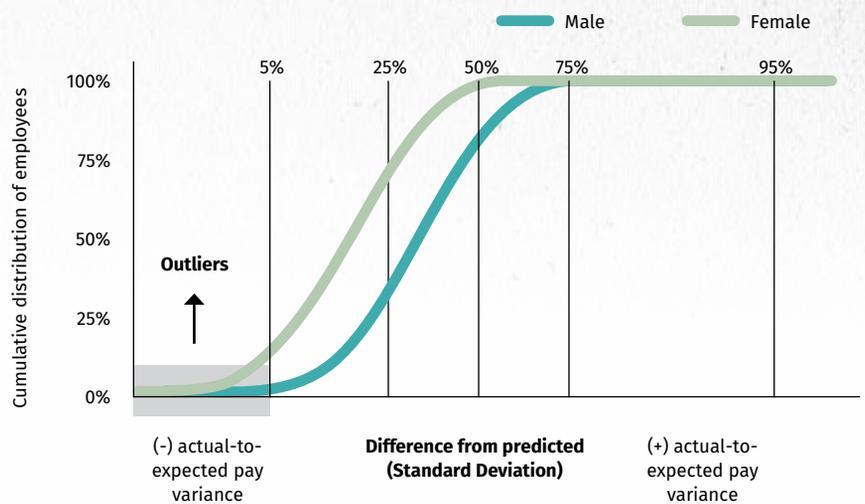
Figure 2 shows how pay distributions for men and women differ at Company A. The outliers have the largest gap between what they actually earn and what the model predicts they should earn. There are more women than men in this group. However, insofar as the orange curve falls on top of the green curve to the right of the 50th percentile (i.e., actual pay is lower than predicted pay), we see the pay differential is not isolated to only the outliers.

If the cumulative pay distribution curve of Company A resembles Figure 2, then long-term remediation may require pay adjustments for a much broader employee group since the problem extends well past the outliers. The goal is to arrive at a distribution that looks more like the one in Figure 3.

The approach toward remediation therefore depends on the nature of the problem, if any. The more systemic the issues across the full population, the less it may make

Figure 2: Women underpaid relative to men

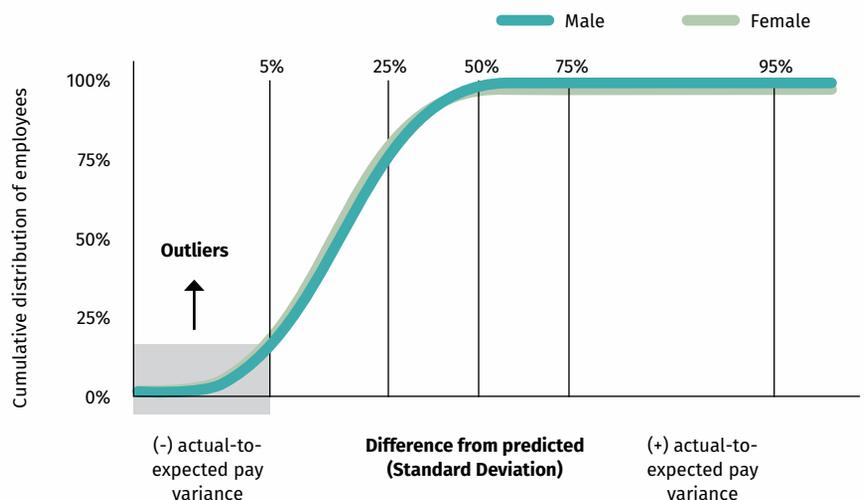
The x-axis shows how far off actual pay is from its expected level; negative outliers are the bottom 5% and positive outliers are the top 5% of the probability distribution. In this regard, the region to the left of the vertical median (50%) dividing line houses cases where actual pay falls below expected pay, and cases to the right involve actual pay exceeding expected pay. The concerning point in this hypothetical example is that in the left region we have a higher prevalence of women, but in the right region we have a higher prevalence of men. For example, at the 25% vertical line, there are about 75% females but only about 35% males.



Source: Equity Methods

Figure 3

At all levels of pay distribution, men and women are evenly compensated.

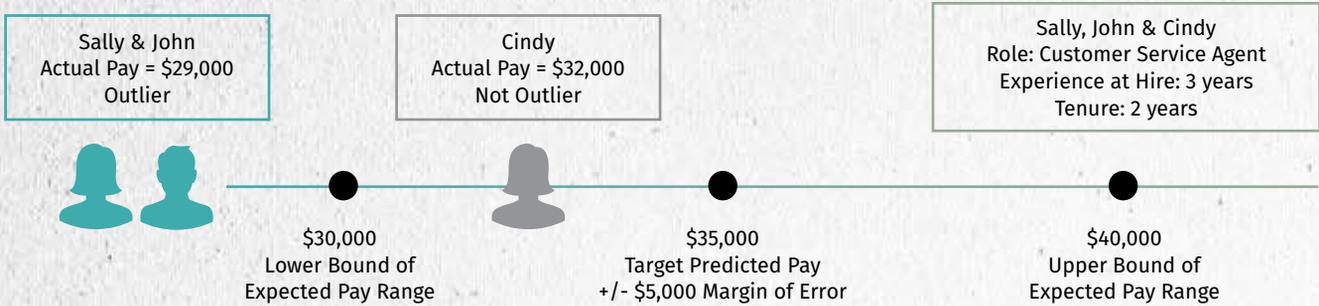


Source: Equity Methods

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Figure 4

Actual pay of outliers Sally and John and non-outlier Cindy versus model-predicted pay range.



Source: Equity Methods

sense to focus on just the outliers – but more on this later.

After examining the aggregate pay gap and distributional properties of pay, it's time to proceed to analyzing the outliers. The first step is to confirm that there are no alternative explanations for their pay that are not present in the data studied. Examples include differences in the amount of business travel, number of direct reports, line of business performance, nature of prior work experience and education. Obviously, if there is a clear and acceptable reason someone's pay is different, it would be a poor choice to give them a raise to be in line with their peers.

This exercise is usually done in collaboration with the appropriate human resources business partners and division executives. By the end, there probably will be answers for some outlier employees but not for others. That brings us to the step where pay adjustments are formulated for employees whose compensation cannot be explained by legitimate factors.

Making Pay Adjustment Decisions

Conventional logic would suggest closing the pay gap is easy – just cut checks to people whose pay is below the model's expectations and, voilà, you're done. Maybe, but usually it's not that simple. First, there are two questions to answer: Who do you pay and how much?

In Figure 4, Sally and John are outliers, as their pay is below the lower bound of the predicted range. Cindy is not an outlier, but her pay is below the model-predicted target level. We'll use this

simplified example as we delve into the pay adjustment discussion.

Question 1: Who Do You Adjust?

1. Adjust everyone whose actual pay is lower than predicted target pay.

If the pay equity problem is structural and not concentrated among a handful of outliers, then it could make sense to make small adjustments to a large group of employees vs. focusing exclusively on the outliers. Said differently, in a company with 20,000 employees – half of whom are women – there could be thousands of \$300 problems vs. a few hundred \$8,000 problems. Using the example in Figure 4, this means adjusting the pay for Sally, John and Cindy.

Easier said than done, of course, which is why this flavor of pay adjustment takes the longest to carry out. It's also why many organizations begin by focusing on outliers before expanding to other segments. This is what the next three approaches aim to do.

2. Adjust everyone whose actual pay is below the predicted pay range (negative outliers).

Even where a pay equity problem exists, outliers may include more than just women and minorities. In that case, the response could be to increase the pay of *all* outliers where there's no valid reason for an actual-to-expected pay disconnect. In our example, this means adjusting the pay for both Sally and John, but not Cindy.

This approach is gender- and race-blind, thereby minimizing legal risk and appealing to a general

Figure 5

Sample analysis of the impact of different remediation approaches on the pay gap and financial budget.

		How much to adjust	
		Adjust to point of statistical insignificance	Adjust to model's expected pay
Who to adjust	Make pay adjustments to all negative outliers (n=100) <ul style="list-style-type: none"> • Systematically cover all potential cases of underpayment • Surest way to address potential issues • Highest number of outliers to review 	Estimated cost: \$1 million Revised pay gap: 1.9%	Estimated cost: \$5 million Revised pay gap: 1.7%
	Make adjustments to negative female outliers (n=50) <ul style="list-style-type: none"> • Targets group that is getting paid less according to the regression model • May not be an equitable solution for male employees in the bottom 5% • Fewer outliers to review 	Estimated cost: \$0.5 million Revised pay gap: 1.8%	Estimated cost: \$2 million Revised pay gap: 1.6%

Source: Equity Methods

sense of fairness. That said, every extra dollar in compensation to a male or non-minority employee will work against closing the gap for women and minorities. Some might argue that pay adjustments should link only to those groups that have some structural disadvantage and need some extra help getting on track. This also involves remediating a larger number of employees and a higher budget as shown in Figure 5. Resolving this dilemma ultimately depends on the organization's compensation philosophy.

3. Adjust only females and/or minorities whose actual pay is below the predicted pay range (negative female and/or minority outliers).

Another approach to closing the pay gap is to increase only the pay of disadvantaged groups that are identified as having structural pay gaps. The benefit to this approach is that it costs less to close the pay gap and has a lower number of employees to remediate. It can also address unconscious elements of bias that need special intervention because the system on its own has failed to yield a suitable equilibrium. In our example in Figure 4, this would mean adjusting Sally's pay only.

It's natural to immediately jump to the outliers, propose pay adjustments and claim victory. But wait, not so fast.

Each company will tailor the remediation approach based on their specific context.

This approach is the least common because most organizations cannot get comfortable with pay adjustment discrimination, even if it's for the disadvantaged. Most CHROs and compensation teams believe that a pay equity study should target every employee whose pay seems to be unexplainable and worth evaluating more closely.

4. Target adjustments by functional group or division.

If pay equity issues crop up more in certain divisions or business lines — or even certain geographies — it may make sense to address those areas first. That way, the company can allocate its pay adjustment budget to where it's needed most.

This remediation approach takes more time and upfront analysis of the problem. But, it lets large organizations with very diverse business units tailor their decisions to the particular issues of each group.

Of these four approaches, there is not one that is unilaterally better. When we work with clients, we introduce each of these and discuss pros and cons in light of the organization's philosophy toward pay and objectives in conducting a pay analysis. It's also not uncommon to adopt elements of multiple approaches.

Question 2: How Much Do You Adjust?

What does it mean to close the pay gap? In a strict mathematical sense, there will always be outliers; the goal is to ensure that *irrelevant factors* like gender or minority status are not the cause of those outliers.

1. Adjust pay to match the model's predicted target pay.

One approach is to consider adjusting pay to the target level as produced by the model. The upside to

this approach is that it typically results in a discernible reduction in the overall gap.

The downside is that it could be unfair to those who aren't outliers. In Figure 4, if only negative outliers' pay was adjusted, this would mean raising pay for Sally and John to \$35,000. However, doing so would cause them to leapfrog their colleague Cindy, who isn't an outlier.

An aggregate adjustment that extends beyond the outliers can make this risk go away. But, it also means shuffling the entire compensation landscape, which has far broader implications. It's also not very realistic to implement in a single merit cycle.

2. Adjust pay to the lower bound of predicted pay.

Another alternative is to adjust the pay of each outlier so that they align with the lower bound of the predicted pay range. In our example, this means adjusting pay for Sally and John to the lower bound of \$30,000. That gets the differential between actual and expected pay into the realm of statistical insignificance. But, it might not do much for the aggregate pay gap across the organization, especially if there are small actual-to-expected pay differences spread broadly across the employee base. In fact, some employees may be beyond the "outlier line" by only a few dollars or even pennies.

Each company will tailor the remediation approach based on their specific context. This usually starts with a cost-benefit analysis of the remediation strategies discussed above. Figure 5 provides an example of what this could look like.

In some organizations, a hybrid or combination of approaches may make the most sense. For instance, there are cases where adjustments can have a more meaningful impact to the regression coefficients if

they go beyond outliers. Suppose the model estimates a 2% pay gap and indicates that anything up to 1% could be caused by random noise in the data. This means that aside from remediating outliers, an additional adjustment of 1% or so for all or most women could swing the modeled pay gap to zero.

When we work with clients, the process is iterative in an effort to understand the model results, socialize them with HR business partners who are closest to the action, and develop potential strategies in light of the overall compensation philosophy and organizational goals.

Getting to the Bottom of the Pay Gap

So, what causes inexplicable pay gaps in the first place? Unconscious bias is but one possible explanation. Other reasons could include:

- Variances in starting salaries that get carried forward over time.
- Similarities in starting salaries that go on to diverge over time.
- Bias in the promotion decision-making process.
- Differing levels of attrition between employee groups.

Each factor has its own nuance. For example, we've seen situations where men turn over at a higher rate and get replaced by other men. Among organizations that are eager to hire, and where the easiest way to navigate to the upper-end of a salary range is by negotiating at the offer stage, this phenomenon can create a structural wedge between male and female compensation. The startling conclusion is that a seemingly unrelated factor (e.g., differing turnover rates between men and women) contribute to the divergence in compensation at the same level and

role. Knowing this makes it much easier to formulate targeted remediation initiatives.

In our experience, pay equity remediation takes a multifaceted approach. Take the time to absorb what the data is telling you, then use what you discover to set realistic goals for each year's pay equity study. This will naturally entail thoughtful pay adjustments, but must go further to address root causes identified in the data.

Training, revising existing policies, creating new processes and employee programs, upgrading talent acquisition approaches, establishing new workforce initiatives, and more are all tools that accompany pay adjustments when adopting a long-run-oriented strategy. The name of the game is to make continuous, data-driven progress toward closing the pay equity gap, wherever it may exist in your organization. **ws**

Takis Makridis is CEO at Equity Methods. He can be reached at takis.makridis@equitymethods.com.

Josh Schaeffer is a director in Equity Methods' valuation and HR advisory practices at Equity Methods. He can be reached at josh.schaeffer@equitymethods.com.

Therese Sebastian is a manager in Equity Methods' valuation and HR advisory practices at Equity Methods. She can be reached at therese.sebastian@equitymethods.com.

Saswati Sen is an associate in Equity Methods' valuation and HR advisory practices at Equity Methods. She can be reached at saswati.sen@equitymethods.com.