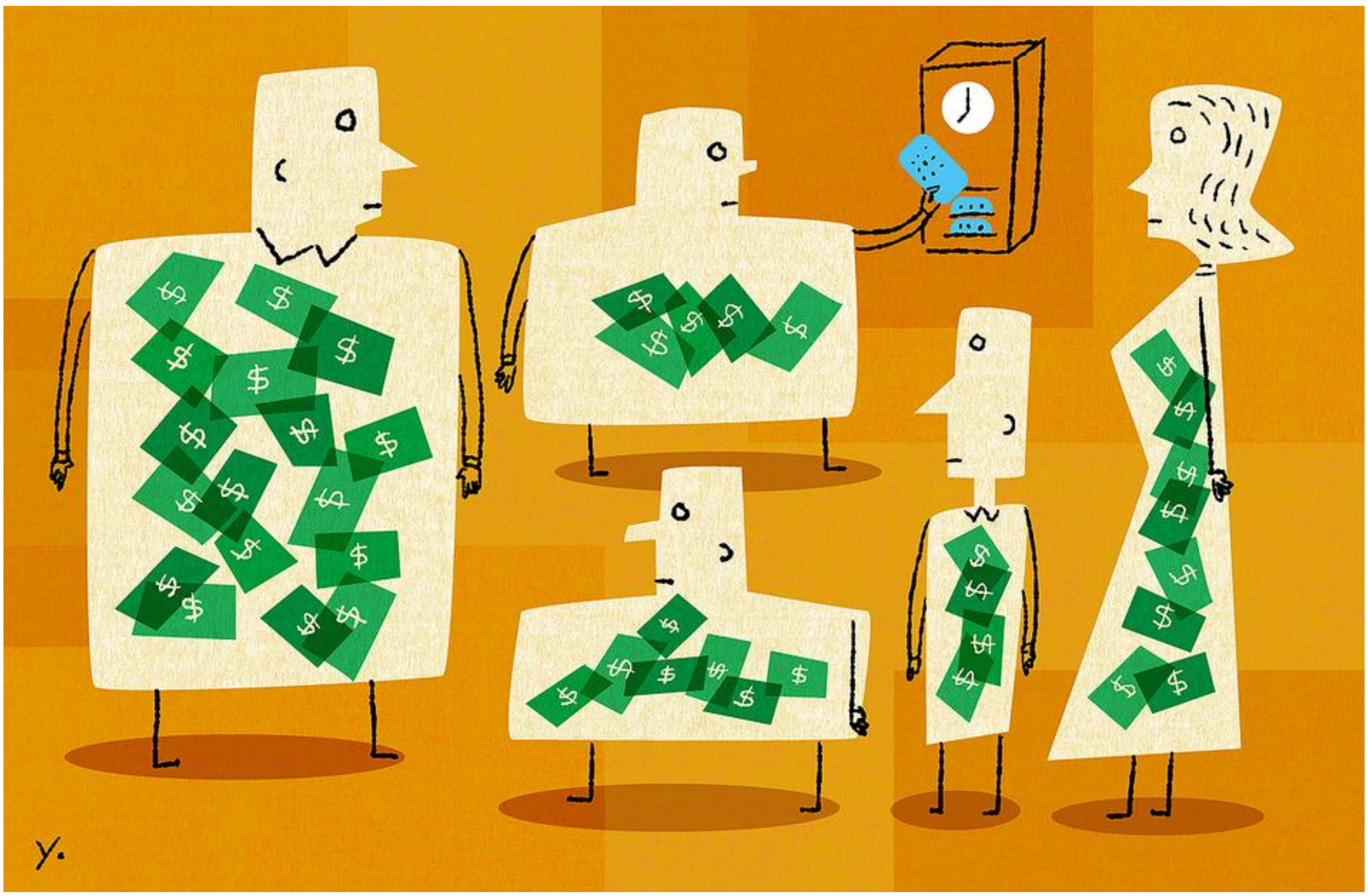
The Downside of Full Pay Transparency

Proponents tout the benefits of sharing pay information across an organization. But for most companies, the costs outweigh the benefits.

Todd Zenger Aug. 13, 2017 10:06 p.m. ET



In many settings, pay transparency can demoralize employees and drive talent away. Illustration: James Yang for The Wall Street Journal

It seems like such a feel-good, modern idea: Allow everyone in a company to know what everyone else in the company is paid.

Such pay transparency has many proponents, who argue that it can help motivate employees, close the gender pay gap, and attract new talent by providing a clear picture of how achievement in the company is rewarded.

But it can also have the opposite effect, demoralizing employees and driving valuable talent away, especially when it isn't clear why some people are paid more than others.

So for organizations considering where to go with pay transparency, it's important to understand why total transparency works in some situations—and can be a disaster in others.

Some easy choices

Let's dispense with what I consider the easy decisions first.

For starters, just about every organization can benefit from some greater level of pay transparency. For instance, if an organization has formal prohibitions on employees sharing salary information with their peers, it's probably time to discard them. Many employees and potential employees find such prohibitions unreasonable, so this is no way to build an effective, motivated workforce. And the legal basis for such rules is at best murky—indeed, a large number of U.S. states now explicitly ban them.

The next step in transparency is actively disclosing the processes or formulas used to set pay for all levels of the organization. There is no clear downside to this. For a pay system to be an effective motivational tool, it has to lay out a clear path for employees to earn more by improving their performance.

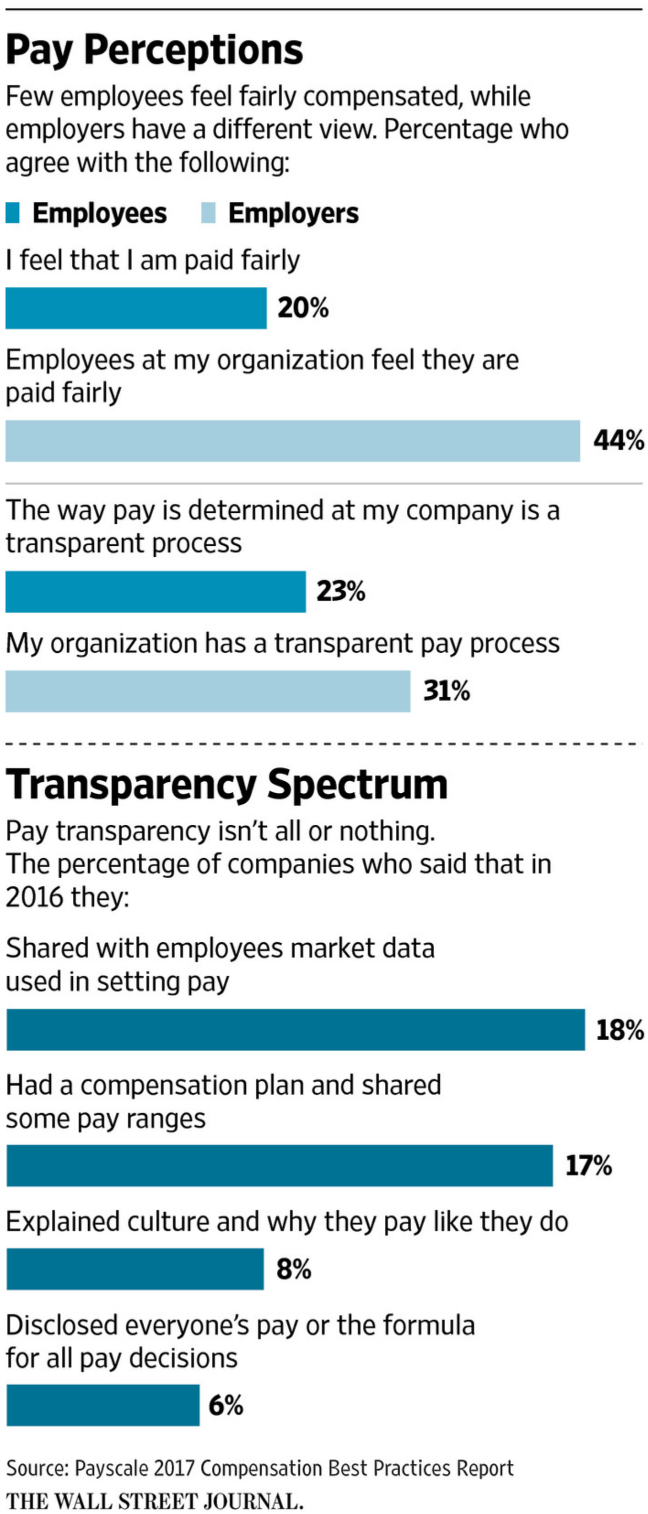
But what about the final step—disclosing everyone's actual level of compensation to all employees? The choice here is more complicated.

Where it works

Full pay transparency works well in two settings. One is where pay levels are based simply on rank and tenure, and perhaps location—not on performance. Think government agencies. On the pay scale for civilian employees of the federal government, everyone can easily find out what someone in a job at the GS-7 level with three years of experience should earn in a given locale. This lets everyone know exactly what they have to do to earn more, and there is no reason for anyone to feel cheated because someone else is being paid more for doing the same job.

Full transparency also appears to work well when everyone in the organization can see how everyone else is performing, especially when performance can easily be measured objectively—for instance, a sales organization that tracks individual sales performance for all to see. Here pay can be based on performance, and the fairness of pay differentials should be clear to all. Another example is small startup firms where all employees are familiar with each other and directly observe each other's performance. It may be difficult to measure performance objectively in these companies, but at least it's reasonably apparent to all what everyone is doing to earn their pay.

Move outside those two types of organizations, however, and full transparency becomes a lot trickier. What if a company wants to reward individual performance, but individual contributions are neither visible to everyone in the company nor easy to measure in a fully objective way? What if an organization is relatively large and the work is highly collaborative, making it impossible for everyone to be aware of all their co-workers' contributions and difficult for everyone to agree on how those contributions should be valued?



In these settings, full pay transparency can do more harm than good.

The fairness problem

The problem is this: People respond in costly ways—their productivity suffers, for instance, or they leave—when they believe others are unfairly receiving higher pay or other rewards. But such perceptions are inevitable when individual contributions aren't easily measured and apparent to everyone in an organization. Employees in this situation not only can't accurately judge their peers' performance, they also tend to dramatically exaggerate their own contributions.

The power of resentment was obvious in a study I recently conducted with Tomasz Obloj of the business school HEC Paris. We looked at an awards program implemented at a European bank selling small consumer loans.

The bank's 164 outlets were divided into four groups, and each group competed for a different number of prizes. Those assigned to groups competing for fewer awards predictably felt slighted. Consequently, the awards program was significantly less effective in boosting the productivity of these groups. In addition, productivity actually declined at outlets that were geographically surrounded by outlets in groups competing for more prizes.

A study of university employees demonstrated the danger of losing employees who feel they aren't being paid fairly. Researchers from Princeton University and the University of California, Berkeley, studied employees in the University of California system shortly after the Sacramento Bee started publishing their salaries. The researchers sent letters to random employees in the UC system, informing them that they could look up their peers' salaries on the newspaper's website.

Surveys done shortly after this found that employees who went to the website and discovered they were paid below the median for their peers were much less satisfied on average with their jobs and more likely to express an intent to depart than those who were paid below the median but didn't receive the prompt to compare their pay. So in this case, full pay transparency encouraged greater overall dissatisfaction and possibly turnover—the exact opposite of the power that full transparency has in the right situations to motivate employees and attract talent.

People also are notoriously poor judges of how their performance compares with that of their peers. In a study of engineers at two major Silicon Valley companies conducted some years ago, I found that nearly 40% perceived themselves as performing within the top 5% of their peers. Ninety-two percent felt they were in the top quartile, and only one engineer felt his or her performance was below average. Such vaunted self-worth may be psychologically healthy, but it makes rewarding performance in a way that employees deem fair rather difficult. Revealing pay levels for everyone in this setting is as likely to highlight imagined inequities as it is real ones.

What choice is there?

In most large, highly collaborative work settings, these problems are impossible to avoid. In those situations, is there any way to still have full pay transparency?

Yes, but an organization in that position is probably better off largely abandoning pay for performance and simply adopting a much flatter approach to pay, basing compensation largely on job title and experience.

If it wants to retain pay for performance, then the best it can do in terms of transparency is to compose and broadcast to all employees an equitable process for evaluating performance subjectively and distributing pay—and not reveal the resulting salaries. Many employees may still disagree with their assessed performance and their pay, but the organization will avoid the toxic effects of a layer of resentment on top of that dissatisfaction.

It is important for companies taking this approach not to set purely objective performance standards for pay, unless these measures fully capture all that the company seeks to motivate. Doing so can discourage employees from collaborating and making the decisions and ethical judgments that are best for the long-term health of the company, as recent research attests.

Given the potential benefits of full pay transparency for some organizations, stopping short of it can be a difficult decision. But it's the right choice for organizations that are in the wrong situation to realize those benefits.

Dr. Zenger is the N. Eldon Tanner professor of strategy and strategic leadership at the University of Utah's Eccles School of Business and academic director of the business school's Goff Strategic Leadership Center. Email him at reports@wsj.com.

Appeared in the August 14, 2017, print edition.