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Is Pay Transparency Good?

Countries around the world are designing pay transparency policies with the intention of combating pay discrimination. The consequences of these policies have been wide-ranging, proving at times to measurably impact productivity, employment, wages and well-being in unanticipated ways. I ask, on the whole, is pay transparency a good thing? I nest four channels through which pay transparency affects behavior and welfare, and I show that with this framework we can design transparency policies capable of increasing productivity, wages and equity. However, the most popular policies - disclosing internal salaries, protecting co-workers who share pay information, publicizing the salary gender gaps of private firms – force trade-offs between lower wages and more equal wages, and create both winners and losers.

I. Introduction

Most pro-transparency initiatives are based on the notion that transparency gives workers more bargaining power: workers can use salary data to negotiate fairer and better pay. Our evidence, however, shows this reasoning overlooks critical forces at play. I will describe these forces and their empirical support, and then nest them in a framework that allows us to see how the design of the pay transparency policy itself allows some forces to subsume others, dictating the impact on productivity, wages and equity.

The popular narrative behind pay transparency policies focuses one use of pay information. The logic follows like this: you're a long-tenured worker in a firm and you don't know anyone's salary but your own. One day, you happen to learn that your three colleagues, who do the same work as you do, have salaries that are 20% higher than yours. This information is valuable; it signals how much value your employer gets from the work carried out in your role. Armed with this knowledge, you confront your boss and ask to be paid as much as your peers. She readily agrees to the raise. Why? This information has given you a new advantage. Without knowing your colleagues' salaries, you might have underestimated your worth to your boss; if you had asked for one, your boss might have easily have denied your request. Now, however, you and your boss have common knowledge of the value your providing; you're confident she can secure the raise, and your boss may fear embarrassment, resentment or even a lawsuit. So, at first glance, it seems that transparency not only increases your pay, but also promotes equity. After all, now all the people doing the same job receive the same wage.

The case of Lilly Ledbetter is commonly cited as an example of this. Ms. Ledbetter received a covert message from a male colleague sharing his salary with her and alerting her to differences in the pay checks they had received year over year, despite doing the same work. She eventually used this information to press legal charges against her employer for unfair compensation, and the case became the basis for the 2009 Lilly Ledbetter Fair Pay Act, which removed the statute of limitation for pay discrimination law suits (Phillips, 2009).

Since a little transparency helped successfully renegotiate salaries, you might think that more transparency would help more employees do the same. That's the reasoning behind many transparency mandates.

But that story is overly simplistic. To begin with, it presumes people perceive themselves as equal earners in the absence of transparency. In reality, people form complex beliefs about whether they are over or underpaid relative to their peers. Moreover, most pay transparency policies reveal information beyond one's immediate peer group. To predict the impact of pay information, one must first predict what the "news" content in pay information will be, which requires data about employee perceptions of others' pay (Cullen and Perez-Truglia, 2018a,b; Kiatpongsan and Norton, 2014; Lawler, 1965). The locus of the news content may even be the earnings of superiors, rather than peers, in contrast to the common pay transparency narrative (Cullen and Perez-Truglia, 2018b).

Second, the narrative overlooks the psychological response to relative pay: learning your standing relative to others can affect happiness, morale, and effort. Rather than feel empowered, you may feel disappointed, discouraged, or disgruntled to discover you are earning relatively less than you previously thought. Akerlof and Yellen (1990) conjectured workers who learned they were underpaid would feel lower morale and reduce their effort at work. Luttmer (2005) proposed this information could be a significant set-back for overall well-being, since happiness hinged on how one's income compared to others. Even if you discover you're the highest earner among all your peers, you may suffer from fear of being resented by others, or feel uncomfortable the circulation of a number that could be construed as your value to society or employer (Cullen and Perez-Truglia, 2018a; Edwards, 2005; Trachtman, 1999). Furthermore, demands for privacy appear to rival demands for information about others' salaries (Cullen and Perez-Truglia, 2018a).

A third facet overlooked is what you may learn more broadly about career options. Suppose you learn about the pay of a co-worker who is more advanced in their career than you are, has more skills and experience on the job. Perhaps the pay information is indicative of how your extra effort will eventually be rewarded. You may even learn about the salary of your boss, and the desirability of that role may depend on what you discover about pay. In sum, you may actually make effort and career choices differently on account of that pay information (Cullen and Perez-Truglia, 2018b; Dewatripont et al., 1999; Gibbons and Murphy, 1992; Gibbons and Waldman, 1999a,b; Harris and Holmstrom, 1982; Holmstrom, 1999; Lazear and Rosen, 1981; Rosen, 1986). To boot, the sheer visibility of that pay information may itself hold the employer accountable for rewarding your hard work and paying you a comparable amount to your boss when you earn that promotion (Mas, 2016).

Finally, the original narrative about pay transparency neglects how the employer responds to broad increases in transparency, when employees have new visibility into pay setting choices. How will the employer make decisions about wages and hiring when they anticipate this information will become widely known? The answer is that they likely set more equal wages, but lower wages overall. To develop intuition for this, imagine a scenario with maximum salary transparency. You not only know the wages of your peers, but you also recognize that your wage will be visible to coworkers. Suppose you demand higher pay than your peers'. The employer can credibly reject this demand, saying, "If I give you a higher salary, I'll have to give everyone else a raise too, and I just can't afford that." Under pay secrecy, you might have been skeptical of such a claim and bargained more aggressively, but due to transparency, you grasp the (true and costly) ramifications of asking for more than the current maximum wage earned by others. Therefore, full transparency leads similar workers to get the same wage. You cannot negotiate this wage upward, and the firm gets the power to set the wage. To maximize its profit, the firm acts like a monopsonist and sets a relatively low wage. Thus transparency increases the de facto bargaining power of the employer, becoming the enforcement mechanism for a low wage (Cullen and Pakzad-Hurson, 2021). These forces are particularly visible in settings where workers have high individual bargaining power to begin with, such as in highly educated, non-unionized labor markets.

Each facet of pay transparency— the psychological ramifications of interpersonal comparisons and privacy concerns, learning about potential earnings, and spillovers between co-worker negotiations— affects effort, wages, inequality and well-being differently. Policy design choices lead one set of forces to subsume the others. For example, a policy that reveals to employees what the average earnings is in their own position encourages employees to re-assess how they stack up to one-another, whereas a policy that reveals the gap in the pay between position levels can largely circumvent peer-to-peer comparisons, while teaching employees about their earnings potential. A policy that reveals pay information internally, keeping the facts contained within the confines of a company, limits information spillovers to employees who all negotiate with a single employer and incentivizes that employer to bargain more aggressively. However, a policy that advertises pay information *across* firms, what I will refer to as "external" transparency, allows employees to redirect their negotiating efforts towards the highest paying firms and counteracts any single employers incentive to contain inter-firm information spillovers and set lower wages.

Beyond the policy implications, we learn general lessons about how the labor market operates through the lens of pay transparency. First, we learn what employees and employers know about wages in the marketplace. Second, we learn about what wages employees care about in the labor market. These facts discipline the information frictions and information spillovers in models of the labor market. They also help explain regularities in the labor market, such as the loading of incentives vertically through promotion.

In the following sections, I first describe the four key mechanisms behind transparency's effects and describe the empirical evidence for these channels. I nest these mechanisms together in a framework that offers predictions for how particular pay transparency policies will ultimately affect productivity, wages and equity, and how institutional factors mediate the impact. Next, I review the consequences of some of the largest pay transparency policies to date in the context of our framework. By and large, popular pay transparency policies evoke forces that equalize pay, and also place downward pressure on wage levels through bargaining and morale effects. Thus, I conclude by putting forth policy designs that could harness the powerful behavioral response to pay information to achieve equity, as well as raise productivity and wages.