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Employee reactions to pay dispersion: A typology of existing research

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ABSTRACT

Pay dispersion has received growing attention in the management literature. Despite an increasing number of studies, research evidence on the effects of pay dispersion has not yet been consistent. The purpose of this paper is to review existing work and to provide a comprehensive theoretical framework that can advance pay dispersion research. Specifically, our framework suggests four unique types of pay dispersion and discusses three existing theories (equity theory, expectancy theory, and tournament theory) to integrate existing research from an employee reaction perspective in the pay dispersion area. We build upon this taxonomy and theoretical explication to suggest an agenda for future pay dispersion research.

1. Introduction

Firm-level research on compensation system structure has been of interest to human resource scholars over the past several decades. One such pay structure property, pay dispersion, has been the subject of investigation in the management literature. Pay dispersion is often defined as "the amount of difference (inequality) in pay created by a firm's pay structure" (Bloom & Michel, 2002, p. 33), and is sometimes referred to as pay variation or pay differential. In compressed pay systems, high and low earners in the pay scale are fairly close to each other in terms of total rewards. Dispersed pay systems, on the other hand, are more spread out so that high earners make much more than low earners in the pay scale.

In the compensation literature, the relationship between pay dispersion and organizational performance has not been clearly established (Gupta, Conroy, & Delery, 2012). In 1992, Becker and Huselid studied the dispersion of rewards in NASCAR competitions. They concluded that large differences in rewards (i.e., high pay dispersion) improved driver performance. They suggested that larger prizes for winning resulted in increased motivation and more aggressive decision making. One year later, Pfeffer and Langton (1993) reported that large pay differences negatively impacted the research productivity of the college and university faculty they studied. They argued that large differences in pay caused perceptions of inequity among faculty members, and that these perceptions of injustice decreased motivation and individual performance. A more recent study (Hunnes, 2009) investigated 1700 firms across an eleven-year period and found "no significant link between wage dispersion and how well the firm performs" (p. 792).

Some researchers have tried to resolve these conflicting findings by suggesting moderators of the dispersion–performance relationship, such as pay basis (Kepes, Delery, & Gupta, 2009; Messersmith, Guthrie, Ji, & Lee, 2011; Shaw, Gupta, & Delery, 2002), pay level (Brown, Sturman, & Simmering, 2003; Pfeffer & Davis-Blake, 1992; Trevor & Wazeter, 2006), pay system communication (Lazear & Shaw, 2007), interdependence (Shaw et al., 2002), and external pay standing (Trevor & Wazeter, 2006). Additionally, some scholars have suggested that the use of certain methodological approaches has created ambiguity in empirical findings

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regarding the effect of pay dispersion on organizational and individual performance (Gerhart & Rynes, 2003; Trevor, Reilly, & Gerhart, 2012). These authors have argued that controlling for various performance-relevant inputs (e.g., human capital, defined as a subset of individual differences — namely those knowledge, skills, and abilities that are positively related to employee performance and productivity; Lepak & Snell, 1999) fundamentally changes the interpretation of results.

Certainly the conflicting findings, moderators, and methodological critiques that have been presented in the literature add complexity to this domain of study. Further complicating this research is the fact that pay dispersion mechanisms occur across multiple system levels (i.e., individuals versus organizations) and can be viewed from multiple disciplinary perspectives (i.e., psychology, sociology, and economics). These different perspectives can cause researchers to have contrasting approaches to management phenomena (Molloy, Ployhart, & Wright, 2011) in general and pay dispersion in particular. Given these distinct approaches, integrating findings into a coherent understanding of the effects of pay dispersion is a challenge. Such integration, however, is important, as it helps researchers identify where we have been and expand our thinking for future research.

In order to form this coherent picture, we review the pay dispersion research findings through an individual-level, psychological lens. In that sense, our interpretations are focused primarily on employee reactions to and functional (individual-level) mechanisms of pay dispersion, and we believe that study of these reactions is an important future direction for this area of research. Although other domains of HR have advanced an understanding of how employees react to HR policies (e.g., employee reactions to performance appraisals, see Cawley, Keeping, & Levy, 1998; Erdogan, 2002; applicant reactions to selection procedures, see Hausknecht, Day, & Thomas, 2004), pay dispersion has lagged behind in this respect — research findings are heavily focused on firm-level (strategic) aspects of pay dispersion (with a few examples; e.g., Trevor & Wazeter, 2006). Through examining individual-level aspects of pay dispersion, we intend to call for research attention to a more balanced and integrated perspective of pay dispersion (firm- and individual-levels; strategic and functional processes). Further, such a perceptual approach aligns with the primary theories that have been applied to pay dispersion (i.e., tournament, equity, and expectancy theories), which imply that employees react to various phenomena and then modify their behavior in a way that affects the firm.

As such, the purpose of this review is to suggest a typology of employee reactions to pay dispersion that stems from relevant theories and then to place existing studies within our proposed framework. Specifically, we make three contributions to the compensation literature. First, we highlight that there are four unique types of pay dispersion at a strategic level, and we provide a two-dimensional framework that describes the distinctions between each type. This conceptualization of different types of pay dispersion has been implied in the literature (Gupta et al., 2012; Trevor et al., 2012), and we use those underlying assumptions to identify and clarify a typology for understanding how employees may react to pay dispersion. Second, we use this typology to identify the current state of pay dispersion research more broadly. From this we conclude that some theoretical mechanisms have received a great degree of attention, while others have not been studied to such an extent. Our review shows that equity theory has been investigated in many contexts, while other theories (e.g., tournament theory or expectancy theory) have gone largely untested in the context of pay dispersion research. Finally, we suggest future directions for pay dispersion by building on our typology and theoretical explications. Testing the strategic-level mechanisms involved in pay dispersion is complex given the existing approaches to pay dispersion. These challenges lead us to believe that a functional perspective (emphasizing employee reactions to pay dispersion) may allow scholars to more fully identify the mechanisms and outcomes of pay dispersion. Such an employee reaction approach may require a focus on the individual level and a more psychological perspective, and thus we propose this is an opportunity for researchers to apply a different paradigm to pay dispersion.

2. Conflicting findings in the literature

We begin by identifying existing empirical evidence regarding the nature of pay dispersion. Many authors have acknowledged two competing hypotheses of the nature of pay dispersion's effect on firm outcomes (e.g., Bloom, 1999; Bloom & Michel, 2002; Kepes et al., 2009) and have introduced their studies as an investigation to determine whether the effect of pay dispersion on firm outcomes is positive or negative. Because this direct comparison approach is common in this literature, we begin by reviewing studies in three categories: (a) those that support a positive relationship between pay dispersion and firm outcomes, (b) those that support a negative relationship between pay dispersion and firm outcomes, and (c) those that show the relationship is more nuanced.

2.1. The benefits of pay dispersion

As mentioned above, Becker and Huselid (1992) were among the first to empirically demonstrate the positive effects of pay dispersion. Analysis of their NASCAR data showed that higher absolute prize differentials between the top finishing positions improved driver performance. Kepes et al. (2009) corroborated this finding by showing that higher pay dispersion between truck drivers was negatively associated with a firm's out-of-service days and positively associated with return-on-equity.

Two additional studies offer less convincing, although still positive, support for the benefits of pay dispersion. Brown et al. (2003) showed that pay dispersion was negatively related to the number of days a patient stayed in a state-run general hospital. Their regression analyses, however, showed that this main effect of pay dispersion was only marginally significant and that pay dispersion was not a significant predictor of their other dependent variables. Similarly, Ding, Akhtar, and Ge (2009) illustrated that one measure of pay dispersion (i.e., pay dispersion between managers and workers) was positively related to sales growth and product or service quality in an archival data set of Chinese manufacturing and service firms. Their remaining measures of pay