9 Reasons why it is good to underpay and overpay some employees

Author: Nyasha Mukechi . January 2020

The principle of paying employees what they are due is an important one especially if the intention is to keep them engaged or with the organization altogether. However, what they are due may differ based on their perspective. The perspective of the employer, which is usually objective and (should) assesses things like performance, is more often different from that of employees, which is usually subjective.

The difference in perspective is usually because, on the one hand, the employer has a responsibility to ensure the success and survival of the business, both of which may be assisted by the cutting down of expenses (e.g. the wage bill). Companies thus do what they can to ensure they do not pay a certain amount for services that do not warrant the expense. In the case of the wage bill, companies usually engage in performance appraisals or salary surveys to assess the validity of the salaries they are paying their employees. On the other hand, it is common for people to believe they are due more than they actually are. This could be a result of the overconfidence effect and the non-satiation nature of human beings. The overconfidence effect refers to nature in people that leads them to believe themselves to be more capable than what their actual performance suggests, whilst non-satiation refers to the nature of humans that does not allow them to be satisfied with less of a good thing when they can have more of it. To keep both parties satisfied, companies must pay salaries that are fair. Salaries that promote internal and external equity, process equity, and should be affordable and sustainable in the long run.

In order to ensure internal equity is being adhered to, salaries must ensure employees feel their pay reflects the relative worth of their job when compared to other jobs in the company, whilst external equity can be addressed by ensuring the salaries in the company are in line with salaries paid by other companies within the market. Failure to address internal equity will result in unsettled employees desiring to understand why their colleague who performs the exact same tasks is receiving more than them when there is not much difference in their performance. Inadequacy in promoting external equity could result in employees being lured to other companies by better offers. Thus, salaries should reflect the value of the job compared to other jobs both in the company and in the market. The principle which is mainly addressed by these two points is that employees should receive equal pay for work done of equal value.

Companies should also make sure salaries promote process equity, that is, salaries should allow employees to appreciate the fairness involved in the salary and benefit system. In addition to this companies should offer salaries that they can afford to pay and sustain in the long run. In other words, companies should “live within their means”. These four criteria are very important and should be taken into consideration when formulating and designing a salary or pay structure.

To find out what other companies in the market are being paid, salary surveys can be conducted. Typical salary surveys provide a wealth of information, among which is information on the different percentiles of salaries being paid in the market. Companies are then able to gauge the market percentile/level they fall into as providers of salaries in that market. The most ideal market percentile to pay differs by company. However, many companies prefer to pay at the market median, which is the level at which half of the companies in the market are paying. This is the level where companies are not overpaying or underpaying employees. Overpaying (Paying above market median) or underpaying (paying below market median) employees is risky as it comes with many disadvantages. For example, overpaying employees can promote complacency and cripple a company’s finances, whilst underpaying employees can push valuable employees away to other companies that provide better salaries. Both these risks exist even at the market median; however, they are amplified in the instances above.

However, there are times where it is good for companies to underpay or overpay certain employees. Below are 9 possible reasons/instances where companies can underpay or overpay employees. (Please note that the list is not an exhaustive one).

Reasons for overpaying employees

1. Attract top talent

Talented employees bring with them benefits that make the company a better place. Some employees have qualifications that are very rare to find, whilst others have qualities that make the workplace a better place for everyone. However, in a thriving job market acquiring such talent has become more difficult as competition has increased. According to the laws of demand and supply, the increased demand for these candidates usually translates to an increased cost in acquiring them. In addition to this, such candidates usually know their worth and the impact they can have on a company, and thus are not afraid to negotiate for higher salaries as they know that someone in the job market will be able to accommodate their requests. Companies are then forced to overpay these employees.

2. Retain key employees

When companies lose employees, they must consider the costs accompanying the replacement. The 2012 Heather Boushey and Sarah Jane Glynn article, “There Are Significant Business Costs to Replacing Employees” states it can cost a company up to 21.4% of the employee’s annual salary to replace them. This amount includes both direct (such as separation costs - severance pay) and indirect costs (such as reduced productivity). When the employee in question is one that did not contribute much to the company’s success and was a poor performer, the turnover costs are simply a price to pay for improved business operations. However, when the company loses their key employees, it is a different story. Such employees are vital to the success of a business, and losing them could lead to a demoralised workforce and a productivity deficit. In short, their loss could actually cripple the company as a whole. Companies must thus ensure they do what they can to hold on to employees that add value. One of the ways to do this is to ensure the employee is not lured elsewhere by higher salaries. It is understandable to overpay such employees in an attempt to retain them. However, increasing the salaries of such employees only may retain them for a certain length of time but in the long run, they may require other motivation to stay, not to mention that this can be very costly for the company. Companies are thus encouraged to make attempts to reduce its reliance on a single individual, perhaps by recruiting replacements who can carry on the job and add value should the key employee decide to leave.

3. Reward long-serving employees

Employees that have been with the company for a long time must be paid in such a way that reflects their contribution to the company. This shows them the company's appreciation for all the years that they remained loyal to the company. Such people know the company culture and at times even help enforce it. They are also able to train newcomers and mentor the less experienced. Losing them could result in ambiguous company culture and a demotivated workforce with no sense of direction and career progression.

4. Reward good performance

To promote process equity, employees need to know that if they perform well, they will be rewarded accordingly. When companies honour this commitment, employees receive additional motivation to ensure they keep performing well. Other employees who have never been awarded for excellent performance will be motivated to also meet the expected targets so that they may also be rewarded. Such systems will ensure that employees that have been at the company for long do not rest on their laurels as they will want to maximise their earning potential.

5. Reduce theft

In the 2012 article named "Can Wages Buy Honesty? The Relationship Between Relative Wages and Employee Theft", Clara Xiaoling Chen and Tatiana Sandino found that a negative relationship exists between relative wages and the amount of employee theft in a company. In other words, Chen and Sandino found that overpaying employees actually reduces/discourages theft from employees. In the report they attribute it to the following reasons:

1. Motivation mechanism, where overpaid employees attempt to return the favour for their high salaries and are motivated to keep their jobs.
2. Selection mechanism, where companies offering to overpay employees are more likely to lure employees that are honest

They found that for every dollar increase in salaries, employees are likely to steal up to almost 40 cents less in inventory and cash.

Reasons for underpaying employees

1. Newcomer/Novice

Employees that have no prior work experience or are new to the company should not be paid the same as long-serving employees as this can cause the latter to feel unfairly treated, which will lead to them being disengaged. The only exception is if the newcomer in question has skills that are difficult to find. As a rule of thumb, newcomers should be put in the first notch of their pay grade and should be afforded the opportunity to prove themselves. As they perform well and display their loyalty they can move up their pay grade.

2. Poor performance

Employees' performance should always be monitored to avoid complacency. Some employees, esp those who have been good past performers or have been with a company for long, can become complacent from thinking that they are irreplaceable. Other employees may perform badly when the work they are expected to do is beyond their capability. In the latter case, it hardly makes sense to pay the employee the same as other competent employees. It is thus important for companies to make certain that they receive value for what they pay for.

3. Company's financial standing

Whilst companies would love to be the company that all top talent flock to when seeking employment, it is sometimes not possible for them to pay salaries that can make that possible. Companies need to think not just about their short-term ability to pay high salaries, but also their long-term capacity to sustain the salaries. As salaries are a contractual agreement, companies must pledge to honour what they know will not come back to haunt them in the future.

4. Economic climate

The economic environment may also make it difficult for companies to offer salaries that are at the market median, lest they are bound to the level of salary should the purchasing power of money increase. In an economy that is unpredictable, it may be wise to pay employees a small portion as a permanent salary. The remaining proportion can be made up of temporary adjustments that track the cost of living. This keeps both parties happy by reducing the burden on the company in the event of an economic change of direction, whilst still ensuring the employee receive the amount that they are due.

Nyasha Mukechi is a Consultant at Industrial Psychology Consultants (Pvt.) Ltd a management and human resources consulting firm.

Phone +263 4 481946-48/481950 or cell number +263 773274381 or email: nyasham@ipcconsultants.com or visit our website at www.ipcconsultants.com

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