A brief guide to some of the most common remuneration theories

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A company's remuneration strategy dictates how much, as well as, how to pay its employees. It outlines how a company uses rewards to attract, retain, motivate and reward employees. In many companies, that includes a well-structured pay structure system and other pay-related policies which are critical to the success of a company. When designed well, these can promote growth at employee level as well as at the company level. In this article, we will discuss a few common remuneration theories that need to be considered when designing a remuneration strategy, as they speak to the behavioural and motivational aspects from an employee's point of view.

Equity Theory

The first is Equity Theory, also known as Adam's Equity Theory. This theory is based on the 1963 paper of behavioural psychologist John Stacey Adams named "Towards an understanding of inequity". The theory primarily focuses on striking a balance between the outputs and inputs of employees in a place of work. If the employees can find a good balance it could result in a more productive workforce. The opposite can be very detrimental to productivity, i.e if employees feel that they are putting more into their jobs than they are getting out of it (i.e. remuneration), they are likely to become disengaged.

Applications of equity theory can be observed in the designing of pay structures among other policies. Two important criteria in designing pay structure are that they should promote internal equity, as well as external equity. Promotion of internal equity speaks to ensuring that employees feel their pay reflects the relative worth of their job when compared to other jobs in the company. Job evaluations can establish internal equity. Where the internal equity looks at jobs within the company, external equity looks at other companies within the market. This is an important point especially as employees can be lured to other companies by better offers. The pay structure should reflect the value of the job compared to other jobs in the market.

As alluded to earlier, perceived inequity can result in lower productivity, higher absenteeism or increase in turnover. It is thus in a company's best interest to invest in improving the engagement level. The benefits of an engaged workforce are far-reaching. First of all, an engaged workforce is one that is mentally and emotionally invested in the company and its goals. Dr Jim Harter, one of the chief scientists at the Gallup Organisation, in an email interview with the Havard Business Review stated that an engaged workforce is "more attentive and vigilant. They look out for the needs of their coworkers and the overall enterprise because they personally 'own' the result of their work and that of the organization." A 2016 Gallup Business Journal article revealed that an engaged workforce is likely to be involved in 70% fewer safety-related incidents. Other Gallup studies showed that engaged employees are 41% less likely to be absent from work and are between 25% and 65% less likely to leave voluntarily leave the organisation. More than this they are reported to be 22% more productive than their less engaged counterparts. An IBM Smarter Workforce Institute survey revealed that about 60% of employees that leave their jobs cite unhappiness with either job or organization as the reason they left. This thus shows that the key to retaining top talent that the company is at risk of losing is investing in employee engagements.

Agency Theory

Agency theory focuses on the contrasting priorities and objectives of the stakeholders of the company, and how employee remuneration should be used to balance those priorities and objectives. Employees and employers are the two stakeholders in a company, the former serving as principal and the latter serving as agents, and the remuneration paid to workers is the agency cost. In general, these two groups have contrasting views on agency costs with employees expecting to maximise agency cost while the employers try to minimize it. Agency theory speaks to how the employer will remunerate employees to ensure their priorities and goals are aligned with their own. A problem usually arises when the employees receive fixed pay and know that regardless of performance their remuneration is guaranteed, thereby luring the employees to moral hazard. Companies thus must seek corporate governance structures that minimise these inefficiencies and reduce moral hazard, by tying the employees' interests to outcomes in line with the expectations of their employer. Companies thus give incentives linked to performance. Such practices, however, may induce a short-term mindset where the employees focus strategies on meeting short-term targets, which may adversely affect long term goals.

Reinforcement Theory

Reinforcement theory hypothesizes that a behaviour that is rewarded is likely to replicate itself. The implication for remuneration would be that if the exceptional performance by employees, either in their work or their conduct, is recognised and rewarded by incentive pay or similar, the likelihood of observing that same level of performance will be increased. Conversely, if exceptional performance is not rewarded, employees may not feel that it pays to perform well, and decide not to put the extra effort again. The theory stresses the importance of rewarding exceptional performance as it helps in moulding and shaping the desired culture. A study by Alex Edmans showed that the introduction of performance-related incentives led to a 44% increase in productivity.

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