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2025 AACA Annual Forum

Pay by Design
Applying Economic Principles to Compensation Strategy

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EVP of Pay Equity and Total Rewards Strategy and Solutions

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The Gist

Every pay program tells an economic story. How employees respond to incentives and even who chooses to join or stay with an organization are shaped by economic principles. Today we'll explore how to apply economic principles to compensation strategy. We'll discuss:

- **Bounded Rationality:** Why employees don't always make "rational" choices.
- **Asymmetric Information:** How differences in what employees and employers know affect trust, fairness, and incentive design.
- **Risk Aversion:** Why most employees prefer predictable income over upside potential.
- **Revealed Preferences:** What employee choices reveal about what people truly value.
- **Selection Bias:** How pay design influences who applies, who stays, and who leaves.

My goal is to provide actionable insights to help practitioners design pay programs that are aligned with how employees actually behave.

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Setting the Context

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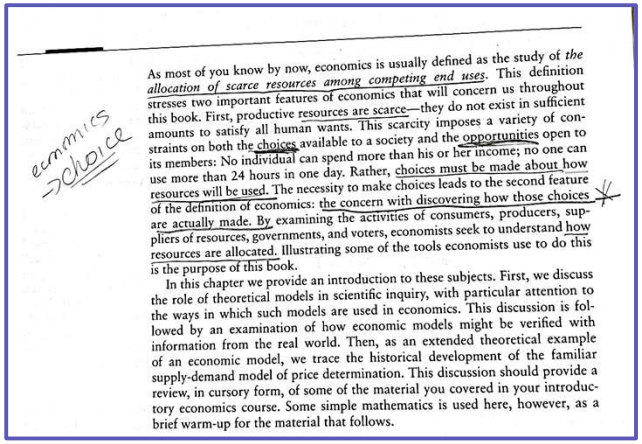
Economics is not...

- All about money and inflation
- The same as finance or accounting
- The stock market

Economics...

Economics seeks to understand (1) how scarce resources are allocated across competing uses, and (2) how these choices are made. Ultimately, economics is about choice.



As most of you know by now, economics is usually defined as the study of *the allocation of scarce resources among competing end uses*. This definition stresses two important features of economics that will concern us throughout this book. First, productive resources are scarce—they do not exist in sufficient amounts to satisfy all human wants. This scarcity imposes a variety of constraints on both the choices available to a society and the opportunities open to its members: No individual can spend more than his or her income; no one can use more than 24 hours in one day. Rather, choices must be made about how resources will be used. The necessity to make choices leads to the second feature of the definition of economics: the concern with discovering how those choices are actually made. By examining the activities of consumers, producers, suppliers of resources, governments, and voters, economists seek to understand how resources are allocated. Illustrating some of the tools economists use to do this is the purpose of this book.

In this chapter we provide an introduction to these subjects. First, we discuss the role of theoretical models in scientific inquiry, with particular attention to the ways in which such models are used in economics. This discussion is followed by an examination of how economic models might be verified with information from the real world. Then, as an extended theoretical example of an economic model, we trace the historical development of the familiar supply-demand model of price determination. This discussion should provide a review, in cursory form, of some of the material you covered in your introductory economics course. Some simple mathematics is used here, however, as a brief warm-up for the material that follows.

Nicholson, Walter. 1992. Microeconomic Theory: Basic Principles and Extensions. 5th ed. Fort Worth, TX: The Dryden Press, p. 3.

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Micro vs. Macro

Microeconomics

- Study of how individuals, households, and firms make decisions and allocate scarce resources.
- Example microeconomic fields
  - Industrial Organization – study of market structures (competition, monopoly).
  - Labor Economics – how workers and firms interact in labor markets (wages, employment, discrimination).
  - Behavioral Economics – how psychological factors affect decision-making.

vs

Macroeconomics

- Study of economy as a whole. It looks at large-scale indicators and aggregates such as national income, inflation, unemployment, and growth, as well as government fiscal and monetary policies.
- Example macroeconomic fields
  - Monetary Economics – money, banking, interest rates, central banks.
  - International Macroeconomics – exchange rates, balance of payments, global financial flows.

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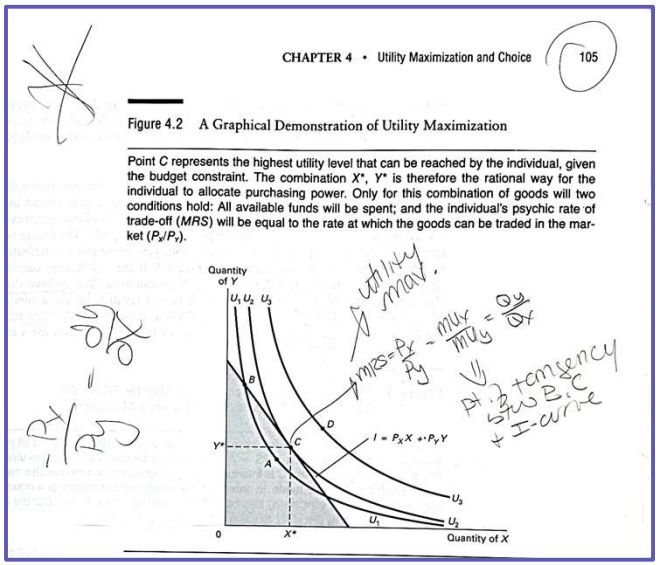
Utility Maximization

- Economists assume that individuals are fully rational and make decisions with the objective of maximizing their “utility” (i.e., happiness, satisfaction) given their budget.
- They use budget constraint functions and “indifference curves” (i.e., preference curves) to identify the optimal combination of goods and services to consume.
- It assumes that individuals have complete information.
  - ✓ Know their preferences perfectly.
  - ✓ Know all the prices of every good and service in the market.
  - ✓ Know their budget.
  - ✓ Can compare options instantly and accurately to see what maximizes their utility.



CHAPTER 4 • Utility Maximization and Choice 105

Figure 4.2 A Graphical Demonstration of Utility Maximization

Point *C* represents the highest utility level that can be reached by the individual, given the budget constraint. The combination X^*, Y^* is therefore the rational way for the individual to allocate purchasing power. Only for this combination of goods will two conditions hold: All available funds will be spent; and the individual's psychic rate of trade-off (*MRS*) will be equal to the rate at which the goods can be traded in the market (P_X/P_Y).

Nicholson, Walter. 1992. Microeconomic Theory: Basic Principles and Extensions. 5th ed. Fort Worth, TX: The Dryden Press, p. 105.

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Reality Is More Messy

- Are people fully rational agents?
- Do people have complete information?
- How do people make decisions under uncertainty?
- Is it even possible to directly measure utility?
- What if we don't have the whole picture?

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Bounded Rationality

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Bounded Rationality

The Concept

- Economists often assume people are perfectly rational: they know all the options, all the consequences, and can always pick the absolute best choice. In real life, people don't have unlimited time, knowledge, or brainpower.
- Bounded rationality means people try to make good decisions, but within limits — like limited information, limited time, or limited ability to process complex information. Instead of finding the "perfect" solution, we often settle for one that's good enough.
- "Shoe Shopper's Dilemma"
  - A simple example is buying a pair of shoes. A perfectly rational shopper would compare every pair of shoes in terms of price, quality, and style across all stores.
  - Most people pick a brand they recognize, ensure the shoes fit and the price is reasonable, and make a purchase. A few, however, might be so overwhelmed with options that they choose not to buy any shoes.

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Bounded Rationality

Application to Compensation Strategy

Overly complicated sales incentive program

- You create a sales incentive program that *appears* to perfectly align incentives, yet it includes lots of tiers, exceptions, formulas, thresholds, multipliers, etc.
- If the program has too many rules, employees can't keep them straight. They might stop trying to understand the whole program and instead focus on a few easy-to-understand rules.
- Because employees can't easily calculate the "optimal" way to maximize their compensation, they might ignore parts of the program. This could lead to focusing on the wrong sales behaviors.
- Most important, if employees don't understand how their pay is calculated, they may assume it's unfair or tilted in the employer's favor. This can hurt morale and weaken the motivational intent of the program.

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Bounded Rationality

Application to Compensation Strategy

Too many benefits choices

- To provide employees with options to personalize their benefits selection, you create an extensive menu of benefits to choose from.
- Employees may feel overwhelmed by too many options and instead of trying to understand their choices, they may default to “what I picked last year.”
- The complexity may result in selecting benefits they’re not likely to use or skipping a valuable benefit that they don’t understand.
- Too much choice in benefits can backfire, leading to dissatisfaction and underutilization, unless it’s accompanied by clear guidance.

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Asymmetric Information

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Asymmetric Information

The Concept

- Asymmetric information is the concept that one party in a transaction has more or better information than the other.
- Because information is unevenly distributed, the transaction may result in inefficiencies, market failures, or might be construed by one party as unfair and lead to distrust.
- "Lemons Problem"
  - A classic example is buying a used car. The seller knows everything about the car. The buyer doesn't know as much and might worry about getting a "lemon." Thus, the buyer is less willing to pay a high price, even for a good car. As a result, sellers of good cars might leave the market, and the market ends up with mostly lemons.
  - One solution is for the seller to offer a guarantee or warranty; another is for the buyer to pay for a third-party inspection. Both solutions involve reducing the information asymmetry to improve the functioning of the market.

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Asymmetric Information

Application to Compensation Strategy

Pay Transparency

- Historically, there's been notable information asymmetry between employees and employers in terms of compensation, with employers having the upper hand.
- How information asymmetry creates inefficiencies?
  - Candidates may waste time applying for jobs that ultimately don't meet their pay expectations.
  - Employers may waste time interviewing candidates who would never accept the offer once they see the pay.
  - Drawn out and stressful negotiations because both sides are "feeling out" the other's reservation wage.
- The availability of crowdsourced data (e.g., Glassdoor), recent pay transparency laws, and a cultural shift toward greater pay transparency are putting pressure on employers to become more transparent.

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Asymmetric Information

Application to Compensation Strategy

Pay Transparency (continued)

- Reducing information asymmetry reduces friction and improves efficiency, making employees and employers better off.
- How reducing information asymmetry improves efficiency?
  - **Better worker-company matching.** Workers self-select into opportunities that meet their pay expectations.
  - **Reduced search costs.** Candidates don't waste energy applying for jobs that do not meet pay expectations and employers don't need to interview them.
  - **More competitive labor markets.** Incentivizes employers to more carefully consider their market position, resulting in more market-aligned compensation.
  - **Improved retention.** Employees who know they're paid fairly are less likely to leave.

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Risk Aversion

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Risk Aversion

The Concept

- Risk aversion means that most people would rather avoid uncertainty, preferring a "sure thing" over a gamble, even if the gamble could lead to a higher payoff.
- "Fair Bets"
  - A risk averse person will refuse a fair bet. A fair bet is one in which the expected value is zero.
  - As an example, you toss a fair coin for $100. If it's heads, you win $100. If it's tails, you lose $100. The expected value of the bet is $0. A risk averse person likely will not participate in this bet.
  - Winning a fair bet adds to the individual's enjoyment less than losing hurts.
- In fact, a risk averse person may be willing to pay something to avoid risk (e.g., buying insurance).
- It doesn't mean people never take risks, just that they usually need an extra reward to make the risk worthwhile.

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Risk Aversion

Application to Compensation Strategy

Overreliance on variable pay

- In the workplace, most employees are risk averse, valuing stability and predictability in their income.
- While variable pay can motivate effort and align incentives, it also increases income volatility. To a risk-averse employee, unpredictable pay is unsettling, even if they could earn the same or more than with a higher fixed salary.
- How can overreliance on variable pay be problematic?
  - **Attraction issues.** Risk-averse workers may avoid the job entirely, shrinking your talent pool.
  - **Retention issues.** Employees who experience volatile pay may leave for more stable jobs.
  - **Reduced motivation.** Employees may disengage if they feel outcomes are outside their control.
  - **Perceptions of unfairness.** Pay outcomes may seem unfair.

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Risk Aversion

Application to Compensation Strategy

Overreliance on variable pay (continued)

- When does it make sense to rely more on variable pay?
  - When performance is easy to measure (e.g., sales revenue, units produced) and controllable by the employee.
  - When business success requires employees to exert "discretionary effort" (e.g., start-up with aggressive growth goals).
  - When your workforce is more risk-tolerant or risk-loving (e.g., younger workforce, entrepreneurial spirit)
  - When fixed costs need to stay low (e.g., early-stage companies using commission pay to avoid fixed salaries).
  - Highly competitive, winners-take-all environments (e.g., hedge funds compensating top traders based on returns generated).

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Revealed Preferences

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Revealed Preferences

The Concept

- Some economists were bothered by the assumption that people maximize an unobservable utility function. This resulted in a theory of revealed preference. This theory is based on observed behavior.
- “Actions speak louder than words”
  - Underpinning revealed preferences is the notion that people’s choices show us what they truly value — even more so than what they say they value.
  - Economists assume that when you pick one option over another, you’re revealing that you prefer it, given the options available and your constraints (e.g., price, time, budget).
  - Instead of asking people what they think they value (which can be unreliable), economists prefer to look at the choices people make.

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Revealed Preferences

Application to Compensation Strategy

Focus on what employees do, not just on what they say

- Stated preferences (e.g., what employees say in surveys) and revealed preferences (e.g., what their actual behavior shows), often diverge. Moreover, it's not always feasible to ask employees questions you'd like answered.
- For example, you may want to know, *"Are you more likely to stay with the company because of your base pay, bonus pay, or long-term incentives?"* Or, you may want to ask, *"Would you be more likely to stay with the company if you received a base pay increase, a bigger bonus, or a larger RSU grant?"*
- Most employers don't ask their employees such direct questions and, if they did, employees may struggle to answer.

"These are theoretical questions requiring abstract reasoning, which are more difficult to answer accurately than questions requiring concrete reasoning, and may lead to unreliable results."

James J., PhD, Experimental Psychologist

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Revealed Preferences

Application to Compensation Strategy

Focus on what employees do, not just on what they say (continued)

- Rather than asking employees these questions, a preferred method is looking more directly at employee actions.
- For example, you may want to conduct a retention analysis. The analysis could include all employees on a specific date (e.g., October 21, 2024) and examine the likelihood that an employee leaves over the following 12-months (i.e., October 22, 2024-October 21, 2025).
- Whether an employee leaves or stays can be statistically correlated with compensation, as well as other relevant factors (e.g., tenure, time in role, performance). For illustration purposes, let's assume the following results:

Receives above average merit adjustment	➔	*33% less likely to quit compared to receiving average merit adjustment*
Receives above target bonus payment	➔	*10% less likely to quit compared to receiving target bonus*
Receives above target RSU grant	➔	*No effect on voluntary turnover*

This hypothetical company may want to focus on base pay changes to improve retention.

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Selection Bias

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Selection Bias

The Concept

- Selection bias occurs when the group you're examining isn't representative of the whole, which can lead to misleading conclusions.
- A few types of selection bias:
  - **Survivorship bias.** Focus on individuals who "survived" a selection process, overlooking those that did not.
  - **Self-selection bias.** Individuals volunteer to participate something, and their willingness to participate is related to the topic.
  - **Non-response bias.** Those who choose not to participate differ systematically from those who do.
  - **Attrition bias.** Participants who drop out are systematically different from those who remain.
  - **Sampling bias.** Method of selection causes some members of the population to be less likely to be included.

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Selection Bias

Application to Compensation Strategy

Selection bias is pervasive in the way we evaluate the effectiveness of pay and benefits programs

- Company surveys only current employees on whether they are satisfied with their pay, missing that dissatisfied employees may have already quit. *(Survivorship Bias)*
- Company evaluates benefits based on current usage, overlooking employees with greater needs who left for better options. *(Survivorship Bias)*
- Company pilots a new benefit and gathers feedback only from users, potentially overstating its overall value. *(Self-Selection Bias)*
- Company benchmarks pay only against industry peers, overlooking whether non-industry roles are competitive in the broader market. *(Sampling Bias)*

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Selection Bias

Application to Compensation Strategy

How to reduce selection bias

- Reducing bias often means expanding whose voices are captured and cross-validating with data, rather than relying on survey responses alone.
- For survivorship bias, in addition to hearing from current employees, use exit surveys and analyze turnover data (i.e., compare people who stayed to those who left).
- For self-selection bias, encourage participation, use random sampling, provide anonymity and confidentiality assurances, validate with objective data (e.g., compare those participating to those not participating).
- For sampling bias, think broadly to ensure the employees you are examining are representative of your workforce.

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Questions?

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With over 20 years of experience, Gail is an eminent pay equity expert who specializes in developing data-driven strategies to promote workplace equity. Gail's career includes roles at Oracle and Warner Brothers Discovery, and she has a rich history at Mercer, where she testified before Congress on diversity and inclusion. Her insights on pay equity have been featured in major media outlets, and she is a respected speaker at industry events. Gail holds a PhD in economics from Claremont Graduate University and a bachelor's degree in business economics from University of California, Santa Barbara.