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IS PAY INVERSION ETHICAL? A THREE-PART EXERCISE

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ABSTRACT

Cultivating moral development and social responsibility have long been goals of ABSEL members. This paper presents a three-part exercise that engages students in an active examination of a social issue that pertains to multiple ethical frameworks. Students are asked to consider the effects from the perspective of someone who benefits from inversion, someone who is a victim of inversion, and someone who is a manager who must decide whether or not to engage in inversion. In order to make a socially moral decision, students are guided to consider at least five approaches to ethical decision-making: a legalistic perspective, ethical egoism, utilitarianism, distributive justice, and Kant's deontological approach. As a result of this exercise, students may have a greater understanding of how their perspective as victim, beneficiary, or decision-maker can influence the way in which they form ethical opinions.

INTRODUCTION

Cultivating moral development and social responsibility have long been goals of ABSEL members. Wines, Anderson, and Fronmueller (1998) content that "business students are indoctrinated into a utilitarian (outcome-based) ethics approach" (p. 72). For the past three decades, presenters at ABSEL conferences have shared their experience of incorporating ethical decision-making into experiential exercises, business games, and simulations. At the 1975 Annual Conference, Jerald R. Smith (1975) discussed the need to develop instructional methods beyond case discussion and lecture to "permit repeated opportunities to respond to business related social and ethical problems" and to help student develop "a fuller understanding of the societal implications" (Smith, 1975, 227). These goals continue to be important to ABSEL participants over 30 years later (Fritzsche & Rosenberg, 1989; Schumann, Anderson, & Scott, 1996; Mujtaba, 1997; Anderson, 2000; Chisholm and Warman, 2005).

Ricci and Markulis (1990) combined study classroom lecture on business ethics with simulation posing an ethical dilemma to evaluate the effect of the lecture upon students' attitudes during the simulation. Similar to Jennings, Hunt, and Cretien (1992), this simulation also involved a large pharmaceutical company. The Ricci and Markulis simulation included an ethical dilemma involving the disclosure of an unfavorable forecast of sales and profits trends for a drug product. Student teams were advised that there was no legal requirement to disclose this information during sales negotiations with clients. The researchers found that only one team of students who did not receive the ethic's lecture made the decision to reveal the information. All other teams did not. This result raises the question: were students displaying a strong preference for a formalistic approach? The pedagogical challenge lies in developing experiential exercises and simulations that require students to go beyond using a utilitarian approach. Wright and Brady (1990) developed vignettes that focused on the distinction between a utilitarian evaluation of alternatives and a formalist, rule-driven approach to ethical decision. Based on student responses to these vignettes, students' preference for utilitarianism or for formalism seemed to be situational. For example, students preferred a formalistic approach to analyzing minority hiring and a utilitarian approach to deciding when a telling "white-lie" was appropriate.

ABSEL members have successfully incorporated a variety of ethical decision-making frameworks in their experiential and simulation pedagogy, and thus providing students with opportunities for moral development. Stacey (1988) used a simulation to give students an opportunity to give students an immediate sense of abuse of employee rights in work. Chiesl (1994) also give students experience with ethical issues involving product design and safety by asking them to allocate advertising dollars among good and bad products. Wines, Anderson, and Fronmueller suggest several cases that require students to become involved with a wide variety of moral principles. McAfee and Anderson (1995) presented students with ethical compensation dilemmas and required that they resolve them using one of three different ethical approaches, utilitarian, moral rights, or social justice. Scott, Schumann, and Anderson (1998) focused on the same ethical approaches for their experiential exercises involving overcharging customers and defective products. More recently, Chisholm and Warman (2005) introduced an e-learning simulation, ExperienceCSR, which guides students through the process of developing a comprehensive corporate social responsibility strategy for a high-tech company.

This paper presents an experiential exercise that focuses on pay inversion, which has both social and ethical implication. Pay inversion is defined here, based on the work of O'Boyle (2001), as "the hiring of new employees at a higher compensation level than that of current employees who have better performance records." Historically, firms have based employee compensation on the skills, knowledge, and abilities needed to perform a job. Similar jobs were grouped together to form pay grades. Then, within each pay grade, raises were determined by merit or a combination of merit and seniority. This pay system was deemed both logical and fair. However, demographic shifts make salary inversion an ever-growing problem. As baby boomers retire, there will be fewer workers to take their place. Labor shortages are expected in construction (Jones, 2002), engineering, health care (Reinhardt, 2003), and even fast food (Hoffman, 1999). All indicators suggest that the starting salaries for younger, inexperienced employees are likely to surpass those of older, more qualified ones with increasing frequency.

Pay inversion will have a profound negative effect on firms if it is not addressed. First, it will exacerbate projected shortages. Baby boomers may decide to retire earlier to extricate themselves from what they see as a demoralizing environment caused by inversion. Second, inversion may encourage employees to move, putting greater pressure on salaries, increasing recruitment costs, and disrupting a firm's ability to plan. Finally, for the majority of employees who stay, inversion will likely lead to lower morale, reduced commitment, and lower productivity.

While the issues described above are important, they are overshadowed by an even more fundamental issue. That issue is whether or not pay inversion is ethical. In this paper, a three part exercise is presented that requires students to use various approaches to examine the ethical issues related to salary inversion. These are: a legalistic perspective, ethical egoism, utilitarianism, distributive justice, and Kant's deontological approach. Students are asked to make this examination from the perspective of someone who benefits from inversion, someone who is a victim of inversion, and someone who is a manager who must decide whether or not to engage in inversion.

PAY INVERSION EXERCISE OVERVIEW

This exercise contains three different but related scenarios. In the first, the student is a new college graduate who is offered a job at $5,000 more than current, more experienced employees are receiving. This scenario raises the ethical issue of whether the student should accept a desirable job, knowing that he/she is the beneficiary of market conditions rather than his/her skills and abilities. The second scenario occurs three years later and puts the student in a situation where a new employee, with less experience, is hired at $5,000 more than the student is receiving. This scenario also raises the issue of whether inversion is ethical, only now the student is the "victim" of market conditions. Finally, the third scenario depicts a situation a few years hence in which the student, who is now a manager, needs to hire a new employee and must determine if he or she should pay $5,000 more than current, more experienced employees are receiving. This scenario forces the student to look at the ethics of pay inversion from a managerial decision maker's perspective.

EXERCISE GOAL AND OBJECTIVES

The goal of this exercise is provide students with an opportunity to exercise professional judgment in an ethical and socially responsible manner. This exercise has the following objectives:

- To familiarize students with pay inversion, its causes and consequences.
- To familiarize students with different ethical approaches and how they may apply to pay inversion.
- To examine the issue of whether an action is ethical irrespective of whether one is the "beneficiary" of an action, the "victim" of it, or a decision maker.
- To show the relationship between ethics and corporate culture, i.e., employee values and attitudes.

EXERCISE PROCEDURE

This exercise is designed to be conducted in numerous ways. However, one procedure would be to follow the steps below:

1. The professor introduces the exercise by defining pay inversion and explaining the moral dilemmas related to it. Suggestions for this appear in the "Introduction" and in the "Initial Ethical Issues" of this paper.
2. The instructor tells the class that the exercise requires that they evaluate three scenarios in terms of several ethical theories. The instructor should then describe these theories. The instructor is free to pick the specific theories or could tell students to apply any/all they chose. We suggest that all five theories (a legalistic perspective, ethical egoism, utilitarianism, distributive justice, and Kant's deontological approach) be applied and our discussion of the theories and our suggestions are provided in the "Debriefing the Exercise" section of this paper.

3. The instructor divides the class into teams of three or four and asks each to select a spokesperson.
4. The instructor provides all groups with Scenario I and asks them to answer the questions at the end of the scenario.
5. When all student groups have finished answering the scenario questions, the representative for each group presents the group's answers.
6. The instructor compares/contrasts/analyzes all of the answers.
7. The instructor distributes Scenario II and asks student groups to answer the questions at the end of the scenario.
8. Repeat Steps 5 and 6.
9. The instructor distributes Scenario III and asks student groups to answer the questions at the end of the scenario.
10. Repeat steps 5 and 6.
11. The instructor debriefs the entire exercise.

EXERCISE SCENARIOS

This exercise consists of three scenarios:

Scenario I-- You have just graduated with a major that is in high demand. For example, you might want to assume that you have a B.S. in Biotechnology and are knowledgeable about mapping the human genome. You have been offered a very attractive job with a medium sized firm. Your starting salary is at the current market wage for your major. A best friend who works for the same firm has told you that your starting salary is $5,000 more than current employees earn because your major is in high demand. They were hired by the firm before the current high demand for your type of skills materialized. Your friend tells you that you will be joining a highly productive department and that your co-workers will be asked to train and mentor you. Assuming that this is your best job offer, would you accept it? Which ethical philosophies would you use to support your position? Why?

Scenario II-- You accepted the job and have been with the firm for three years. You have received excellent annual evaluations and significant merit rises. In fact, your supervisor said you will likely be promoted within the next few years. Recently, the firm's business has improved dramatically, and your department needs to hire a new employee. Given the shortage of applicants, the current average market wage has increased, and your boss offered a new graduate from your alma mater $5,000 more than you are receiving. Given your superior skills, you will be asked to train and mentor the new hire. Do you agree that the firm should pay the market rate? Which ethical philosophies might you use to support your position? Why?

Scenario III-- Based on your skills, performance, and years with the firm, you have recently been promoted to manager and given a significant pay raise. Because business continues to improve, you must hire one additional person. You return to your alma mater. Unfortunately, the supply of applicants is still small, and the demand is still large, so the market average starting salary is $5,000 more than the salary of any of the more highly qualified employees you supervise. Would you offer that amount to a new employee? Which ethical philosophies would you use to support your position to your boss and subordinates? Why?

DEBRIEFING THE EXERCISE

An instructor may want to begin discussing the exercise by defining pay inversion and distinguishing it from pay compression. Examples of inversion (e.g., the AACSB study) could be described followed by an explanation of why some consider it a problem.

Instructors may also want to mention that pay inversion may be accompanied by related events that create ethical issues. For example, when firms hire new employees, their high salary and better benefits may be kept secret from other employees. This may be inconsistent with the notion of organizational transparency and shared governance. Students could be asked under what circumstances, if any, pay secrecy is ethical.

A second issue is the moral dilemma that inversion creates among current employees between being a team player and sanctioning an action one may believe is unfair and unethical. During the recruiting process, each employee must decide whether to actively help recruit the applicant, minimize one's effort, or go so far as to sabotage the process. Once the new employee starts working, current employees who are asked to mentor the new member face a similar dilemma. Again, one must decide how well to perform these mentoring tasks, if at all. Students could be asked how they would deal with the dilemma and whether or not the methods they've chosen are ethical.

A third ethical issue deals with honesty. At some firms, there is an understanding that if one gets a better salary offer, the firm may match it. This places the firm in the position of needing to determine the validity of the offer and taking action if the employee has misrepresented it. Firms may be forcing employees whose pay is inverted to be dishonest and falsely represent themselves as looking for a new job. These other firms bear the expense of an employee who is trying to deal with inversion, not one who is seriously considering leaving. By requiring employees to behave unethically to get a higher salary, the firm itself may be guilty of unethical behavior. Students could be asked if it is ethical to seek a better offer solely to have leverage for a pay increase.

Another ethical issue focuses on openness and telling the truth. When employees join a firm, they typically are told that rewards, including annual pay raises, are based on job duties, merit and/or seniority, i.e., pay is based on job performance within each pay grade. Employees are not told that their future salary is partially a function of market conditions when hired. Pay inversion is inconsistent with the expected relationship between pay and performance.

Students may be asked how they would feel working in such an environment.

In addition to the above ethical issues, an instructor may also want to discuss the typical explanation for salary inversion which is that the "market" demands it, i.e., firms must pay market rates to hire people who are in short supply. Some, however, question the validity of the market argument because when someone says that the external "market" for a particular job is $X, the person is typically referring to an average. Some are paid less, while others are paid more. Furthermore, when economists talk about "the market," they are typically referring to a commodity, e.g., light sweet crude oil. However, one could argue that employees are not commodities. In addition, the "market" has difficulty taking into account real life factors such as the cost of living or the quality of life in an area and the unique qualities of the applicant or the job. The market argument also may run counter to the "comparable worth" notion that pay should be equal for jobs that require comparable skills, effort, and responsibility and that have similar working conditions. Students may be asked whether or not they think "the market" argument is valid.

Pay inversion has also been justified by saying that there are two different markets, one for current employees and one for new employees (See Gomez-Mejia & Balkin, 1987). Starting pay is tied to external markets and set high to attract people who are in short supply. On the other hand, current employees who often have limited mobility can be retained at lower salaries. Students may be asked whether or not this two-tiered system is ethical.

Firms often argue that they don't have funds to pay all current employees market rates, thereby eliminating pay inversion. This explanation is plausible if a firm is weak financially. However, the "lack of funds" argument is less compelling (and less honest) when firms expand their facilities, buy new equipment, set up new divisions, give raises to top executives, and hire more managers. Students may be asked about the ethics of this "lack of funds" argument.

After discussing the topics presented above, an instructor may want to review how students answered the questions at the end of each scenario. Were they more likely to believe that inversion is ethical if they were the beneficiary rather than the victim? How many students agreed to invert pay when they were placed in the manager's role? What ethical rationale was used in each scenario? Students are likely to believe that it is ethical to accept a new job at market rates (Scenario 1), but that it is unethical for the firm to hire a new employee at a higher salary than they are making (Scenario 2).

If the faculty member asks students to evaluate each scenario in terms of the five ethical theories suggested earlier (legalistic approach, ethical egoism, utilitarianism, distributive justice, and Kant's deontological approach) then students will more likely use the legalistic approach and ethical egoism (discussed below) to defend taking the job in Scenario 1 since both theories focus solely on benefits to the individual. They are likely to use distributive justice and Kant's moral imperative to justify the unfairness of Scenario 2 since these theories consider the impact of a decision on various stakeholders (e.g., current employees). In Scenario 3, students are likely to use utilitarianism and weight the advantages and disadvantages of paying a market salary, as is widely done in industry.

At this point, one could ask whether the ethics of an action should depend on whether one is the beneficiary, a victim, or a decision maker. One could argue that ethical correctness should be independent of one's role.

In discussing these issues, the instructor may want to avoid using the terms "beneficiary" and "victim" because they are judgmental, implying that inversion is unfair. Neutral terms such as "being paid more" (not the beneficiary) and "being paid less" (not the victim) could be used. Alternatively, one could use the terms "at market" or "below market."

When conducting this exercise, we suggested that faculty ask students to examine the three scenarios in terms of some specific ethical theories or any/all of them (Step 2). To assist faculty, we will now examine pay inversion in terms of the five different ethical theories mentioned earlier.

Some will argue that the legalistic approach and ethical issues are separate and that legalism isn't really an ethical theory. However, since it is used by many in business to justify behavior, we have included it. The legalistic approach to ethics (Velasques, 1992; Beauchamp & Bowie, 2001) contends that if an action is legal, then it is ethical.

Instructors may want to ask if any laws make inversion illegal. Since pay inversion typically affects older employees, some may say it is illegal because it discriminates based on age. Under the 1967 Age Discrimination in Employment Act (ADEA), plaintiffs must bring a claim on the grounds of discriminatory intent or adverse impact. Recently (Wall Street Journal, March 31, 2005. B1) the Supreme Court ruled that firms can validly argue in their defense that pay inversion is a "business necessity." Thus, the bar for winning adverse impact cases based on age discrimination is high. Instructors may want to ask if they see any disadvantages to using legalism to justify inversion. Do they think it will cause employees to also adopt an "if it is legal, it is ethical" philosophy? Should employees judge all behaviors only in terms of whether they are legal? What would be the ramifications of this approach? Is a legalistic corporate culture one students would recommend?

As a moral philosophy, ethical egoism states it is ethical to act only in one's own best interests without regard for others. It has been argued that most businesses are fundamentally egoistic (Beauchamp & Bowie, 2001) and just look out for themselves. While one may consider this harmful to society, Adam Smith suggests that looking out for one's interests will ultimately lead to the greatest good for the greatest number. (Beauchamp & Bowie, 2001). Students could be asked if they believe Adam Smith's argument. Instructors may want to ask whether justifying salary inversion based on ethical egoism has any negative consequences. For example, the instructor could ask whether this reliance on ethical egoism will encourage employees to also adopt the expediency principle and "look out for number one." What are the consequences to the firm and the effect on its corporate culture if everyone adopted this moral philosophy?

Utilitarianism is a teleological moral philosophy that compares the costs versus the benefits of an action and bases decisions on what helps the most with the least harm. It focuses on the consequences of one's actions and not the intention. Unlike ethical egoism, this approach looks at actions in terms of how outcomes affect all stakeholders, not just one individual. Based on utilitarianism, one could justify pay inversion by arguing that its benefits to stakeholders outweigh the costs. One could argue that paying a market salary attracts highly qualified applicants. Inversion ensures that the position will be filled quickly, reducing recruiting costs and eliminating harm to current employees by reducing, or at least not increasing, their work load. This argument would be particularly compelling if the position would be lost if not filled quickly. Instructors may want to explain that one of the major problems with utilitarianism is the difficulty of identifying the various stakeholders, assessing their importance, and quantifying the costs and benefits to each. A key factor in determining whether or not inversion is ethical in terms of utilitarianism may depend upon how management presents the costs and benefits of pay inversion to employees. Is their presentation balanced (costs as well as benefits), transparent, and honest? Do they explain what the firm intends to do about pay inversion in the future?

The fundamental principle of distributive justice is that equals should be treated equally (Rawls, 1971 cited in White, 1993). An instructor could ask whether salary inversion violates this principle. If distributive justice were adopted as a firm's ethical philosophy, what would the corporate culture be like? Would this be a good company to work for? Why or why not? An instructor may want to ask what the applicant in Scenario1 would need to do in order to meet the requirements of distributive justice. Asking to be paid less than what was offered and less than what current employees are earning would meet the requirements, but would this ever happen? Instructors may want to mention that management theorists have developed their own versions of distributive justice, one of which is Adams' theory of equity (Adams, 1963). Here, employees determine if they are being treated fairly by comparing their contributions to the firm (inputs) against their rewards (outcomes) to those of one or more other employees. If an individual believes that this ratio is equal, then the person views the situation as being fair. If the ratio is perceived as being unequal, the person will view it as being unfair. Employees could see salary inversion as being unfair based on equity theory since the new hire's inputs are less and the outcomes (salary) are more. Instructors could ask what employees might do to restore equity. Some of the best employees may respond to inequity by leaving. Others may work only at the minimum level or reduce their discretionary organizational citizenship behaviors such as not providing extra help to co-workers or customers (see Organ, 1994). Doing so may cause other employees to do extra work, thereby creating friction. As such, salary inversion seems inconsistent with the notion that an act should foster cooperation if it is to be considered ethical under distributive justice (Pincus-Hartman, 1998). The instructor may want to ask students how they might try to achieve equity in response to salary inversion and whether the behaviors they've chosen are ethical. Another management theory related to distributive justice and fairness is psychological contract theory (Rousseau & Parks, 1992). It argues that employment offers and acceptances are based on mutual understandings. Traditionally, the psychological contract includes the provision that rewards are based on job performance. An instructor may want to ask: does salary inversion break the psychological contract? Is this unethical?

Under Kant's ethical imperative approach to ethical behavior, respect for humans is crucial (Velasques, 1992). Likewise, Rowan (2000), notes the importance of respect to ethical behavior. Kant argues that to be respectful, one should treat people only as they have freely consented to be treated beforehand. An instructor could ask whether most employees would consent to salary inversion, especially in the long term. Does hiring someone with fewer job skills at a higher salary show respect for current employees? Is inversion ethical under Kant's theory? In addition, one might infer that Kant (Pincus-Hartman, 1998) would ask what would happen if salary inversion became a universal law and was widespread, i.e. pay for all employees was primarily based on when one was hired and the market at the time, not necessarily the traditional pay criteria of job duties, seniority and/or job performance. Does minimizing the value of seniority and/or performance lead to a moral corporate culture that respects individuals?

Instructors may want to discuss ethical ways of addressing pay inversion. For example, one option is for firms to adopt a clearly communicated two or more tiered pay system that involves different expectations for new hires and current employees. New hires would receive more pay, but would be required to meet higher performance standards. Current employees, while still having to make a significant contribution, would have more flexibility in determining how they would make their contribution. In effect, current employees would be exchanging lower pay for more freedom to do the tasks they prefer. In addition, to be equitable based on the theory of distributive justice, current employees should also be given the option of meeting the higher standards and receiving a higher salary.

A second ethical option would be for firms to address pay inversion by compensating current employees in other ways. Monetarily, current employees could have first choice of overtime or training that will lead to position upgrades. When possible, current employees could be given one-time bonuses to compensate for lower salaries. Non-monetarily, current employees could be given first choice of offices, company cars, and other perks. This is consistent with Ross' duty of beneficence (Boatright, 2003) which requires that firms do what they can to improve the condition of employees.

A third ethical option is for firms to refrain from salary inversion and base starting salaries on the internal market rather than chase the external market. Some firms already do this and compete on the basis of their other strengths. By not chasing the market, firms are more likely to attract employees who join the firm for reasons other than salary and who are more likely to stay. These organizations recognize that not every firm can compete on the basis of price (salary).

A fourth alternative is to hire new employees at the market rate but tell them that they will not be granted any salary increases for a certain time period or until equity is restored. Limiting pay increases when an employee is overpaid is a common practice in industry when mergers occur. This approach may not immediately or completely restore pay equity but it shows that a good faith attempt is being made.

CONCLUSION

In this paper, we have presented a three-part scenario exercise that focuses on ethical issues related to an emerging compensation issue, salary inversion. The exercise has six distinguishing characteristics:

1. It focuses on pay inversion, an issue that may affect many students given current and future labor trends. As an aside, faculty members who have first hand experience with inversion may enjoy examining this issue and learning how students feel about it. However, in recent years, this system has come under siege by a new phenomenon–pay inversion. A recent American Association of Collegiate Schools of Business study (LeClair, 2004) shows that new Ph.D.s hired by member schools received an average of $92,500 compared to $87,500 for currently employed assistant professors and $88,800 for associate professors.
2. It examines inversion from three different and perhaps conflicting perspectives: beneficiary, victim, and decision maker. This forces students to confront the issue of whether ethics is situational.
3. It helps students understand various ethical theories and takes each theory from the abstract to a concrete application. Although others could be used, the exercise shows how five theories could be applied to pay inversion.
4. It demonstrates that ethical philosophies and corporate culture are interrelated, i.e., the ethical philosophy that a firm implicitly or explicitly adopts affects employee behavior, motivation, job satisfaction, loyalty, and retention.
5. It requires students to confront the issue of whether pay inversion is ethical and whether there are more ethical alternatives to it. One would suspect that most managers ignore the ethics of pay inversion because they believe it is a fact of life and that they have no choice but to pay market salaries.
6. It is a flexible exercise. It can be used in classes such as business ethics, human resource administration, compensation management, and organizational behavior. It can be shortened from 50 minutes to 20-30 minutes by eliminating group work or by having groups meet outside of class.

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