5 Mitigation Strategies To Address Employee Pay Gaps

By **Quenton Wright** (May 30, 2019, 12:59 PM EDT)

Employers want to do the right thing. In the United States, employers are facing significant pressures to reduce or eliminate pay gaps between different employee populations.

An audit of a business' pay outcomes may reveal statistically significant gaps based on gender or race/ethnicity. Once a gap is identified, employers may struggle with how to best respond as it presents a complex set of legal questions and practical implementation issues. This article focuses on the implementation issue by examining five mitigation strategies that an employer might consider.[1]

Quenton Wright

Putting Pay Equity in Context

Pay inequities can create significant risks for employers. Private litigation by affected employees, individually or as a class, is a constant threat. A patchwork of federal, state and local laws makes it difficult for employers to stay compliant and assess their risk under an array of different regulations.

For many employers the reintroduction of the U.S. Equal Employment Opportunity Commission's EEO-1 Component 2 reporting process provides an added incentive to examine their pay structures. By the end of September 2019, U.S. employers with more than 100 employees must provide the EEOC with pay data categorized by race/ethnicity, gender and job category. The EEOC could use this data to launch investigations of employers with potential pay equity concerns. Such data may also be accessible to potential litigants through Freedom of Information Act requests.

Pay inequity also creates risk beyond pay discrimination lawsuits. Shareholders increasingly are demanding that companies disclose pay parity information or even unadjusted raw pay gaps. Businesses that fail to examine these questions may suffer reputational harm and struggle to attract a diverse workforce.

Pay Audits

A pay audit provides the employer with the information necessary to identify and address potential pay equity gaps. A properly designed and executed audit accomplishes a number of goals. It provides statistical insights into an employer's potential areas of legal risk. It equips the employer to pay its employees more fairly. It reveals the implications of current pay practices and can also identify the lingering influence of historical decisions. Further, an audit may improve the company's image as a progressive employer.

Pay audits are not without risk. If approached with incomplete or unreliable data, or designed without

careful consideration of the employer's pay practices and the legal climate in which it operates, the audit's results could lead to incorrect pay adjustments or increased litigation risk. To avoid the audit becoming a flash point in litigation it needs to be conducted with an attorney's oversight to ensure attorney-client privilege. More broadly, an audit should be conducted with a clear goal in mind so the organization can act on results in a constructive way. While a human resources department's concerns with overall fairness may lead it to focus on individual employees, a legal department's top concern may be group differences.

Three Key Decisions in Developing a Mitigation Strategy

After conducting the pay audit, the employer will have important decisions to make. Often, the first step is to identify what results will be treated as actionable, even if they are not statistically significant. Identifying a specific statistical goal at the outset of the process can provide structure for developing a mitigation strategy. The courts generally conclude that group differences in excess of -2 standard deviations (which is approximately equal to a p-value that is less than 0.05) are unlikely to have occurred by chance alone.[2] When the group difference is statistically significant the burden is on the employer to explain the group difference.

As such, employers typically choose to mitigate group differences at a threshold below -2 standard deviations (e.g., -1.5) to build in a buffer. It is important to remember that a pay analysis is conducted as of a particular point in time. As new employees enter the population, employees terminate and other employment transactions take place, the outcomes will change. Hence, in managing legal risk, it is often useful to build in a buffer to continue to manage risk over time.

Once the employer identifies which groups it will seek to mitigate, a second decision is who in the target population is eligible for a pay increase. Typically adjustments are limited to the gender, race or ethnic group that is statistically significantly underpaid (i.e., the protected group) after accounting for the factors in the pay model. Sometimes employers adjust individuals in the comparison group to provide some cover for the equity project or because they want to ensure that all employees are paid equitably.

However, an employer should be aware that adjusting both protected (e.g., women) and comparator (e.g., men) employees simultaneously is a tricky business. In the case of mitigating a female pay gap, any male pay increases are likely to increase the budget needed to bring the female pay gap down to the statistical goal. In the next section I cover five strategies for allocating the budget to employees in the target group.

Establishing a budget is a third essential component of a mitigation strategy. A mitigation budget takes into account the number of protected employees, the magnitude of the pay difference for the group, and the employer's target standard deviation. Some employers may wish to completely close an identified gap and will budget accordingly.

For example, if the model reveals that a group of 100 women are underpaid by an average of $3,000 each, a budget of approximately $300,000 will be needed to reach parity. In practice, many employers budget to reduce gaps to statistical or practical insignificance, rather than trying to close them completely. Because the model is subject to measurement error and omitted variable bias, targeting a difference of zero may place an over-reliance on the model. An estimated difference of exactly zero is statistically very unlikely.

Five Approaches to Mitigating Pay Inequity

Several approaches are available to help employers determine how to disperse the budget to employees in the protected group. Each approach has pros and cons, taking into consideration the employer's unique circumstances. To a large extent, an employer's size, available staffing and financial resources

will determine which strategy is the right fit.

It may not be feasible for a resource-thin business to review hundreds of pay decisions at the individual level or to implement an approach using complex computations. Smaller employers also have comparatively less risk due to their smaller populations and fewer employees driving statistical significance. Larger organizations with more employee groups often take a programmatic approach to mitigation.

1. Cohort Review of All Targeted Employees

Regardless of the constraints on the employer, it is always preferable to conduct a cohort review of the individuals in the target group relative to their comparators. This ensures that there are no important factors omitted from the pay model and that appropriate decisions are being made on an individual basis. If the group is large, then employers can select a sample of the most underpaid protected individuals to review as a first step.
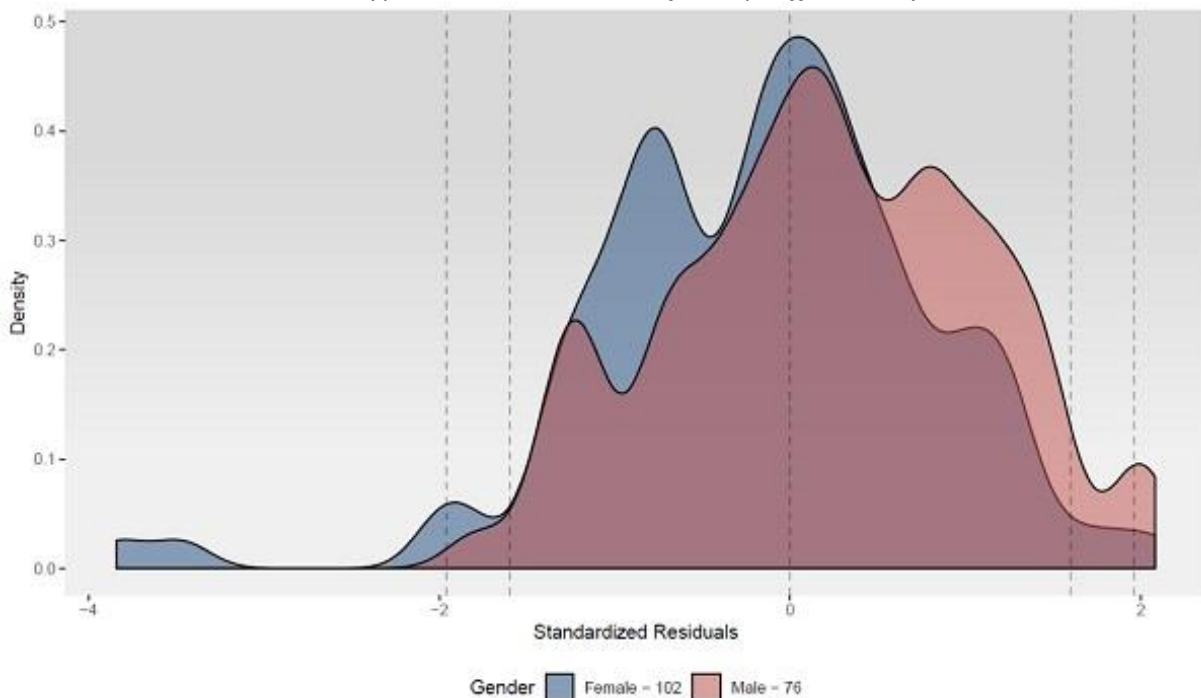
Individual review is critical to ensure that the model accurately reflects the key factors that are used in the decision-making processes. The ideal mitigation strategy is to review each protected employee in the group and make adjustments relative to their cohort. If this strategy is not practical for the employer, then one of the subsequent strategies may be selected.

If the cohort review supports the model, it can be helpful to understand the underlying pay distributions between the protected and comparator groups. In the examples that follow, the protected group is women and the comparator group is men.

2. Targeting Outliers

The second approach to mitigating pay inequities is to target pay increases only for outlier individuals who are found to be driving statistical significance. This approach may make sense in cases like those shown in Chart 1, where compensation for some female employees is significantly out of step with that for men, based on the model.

Chart 1: First Hypothetical Distribution of Group Difference by Gender

Source: CRA analysis

Chart 1 shows the normalized difference between an employee's actual pay and the applied model's prediction of what that employee should be paid given his or her observed characteristics in the model, with the zero point representing employees whose compensation is equal to what the model predicts. The blue area illustrates where women are within the distribution, while the red area shows where men are in the distribution. Note that a cluster of significantly underpaid women appears at the far left, potentially driving the group gender pay difference.

When working with results like these, a close look at the underlying population may show that the model did not adequately account for factors that could explain the pay of employees in the outlier group. The lower pay of an outlier population may be legally justified. For example, the company represented by Chart 1 might find in their cohort review of these several women that they are working on projects that are less technically involved, and so their pay reflects a contribution that is not as valuable to the organization.

Provided that the discrepancy can be justified, it might not need to be mitigated, as long as this explanation is permissible under the local and federal laws. If the permissible factor can be quantified, it can be added to the analytical model to confirm whether the justification explains the wage differential.

3. The Peanut Butter Approach

Distributional shifts between populations are a common problem identified during pay audits. Chart 2 reflects a distributional shift between pay for men and women, with women on average earning a little less and men a little more. Here there is no obvious outlier group, but rather a consistent discrepancy between the two groups.

Chart 2: Second Hypothetical Distribution of Group Difference by Gender
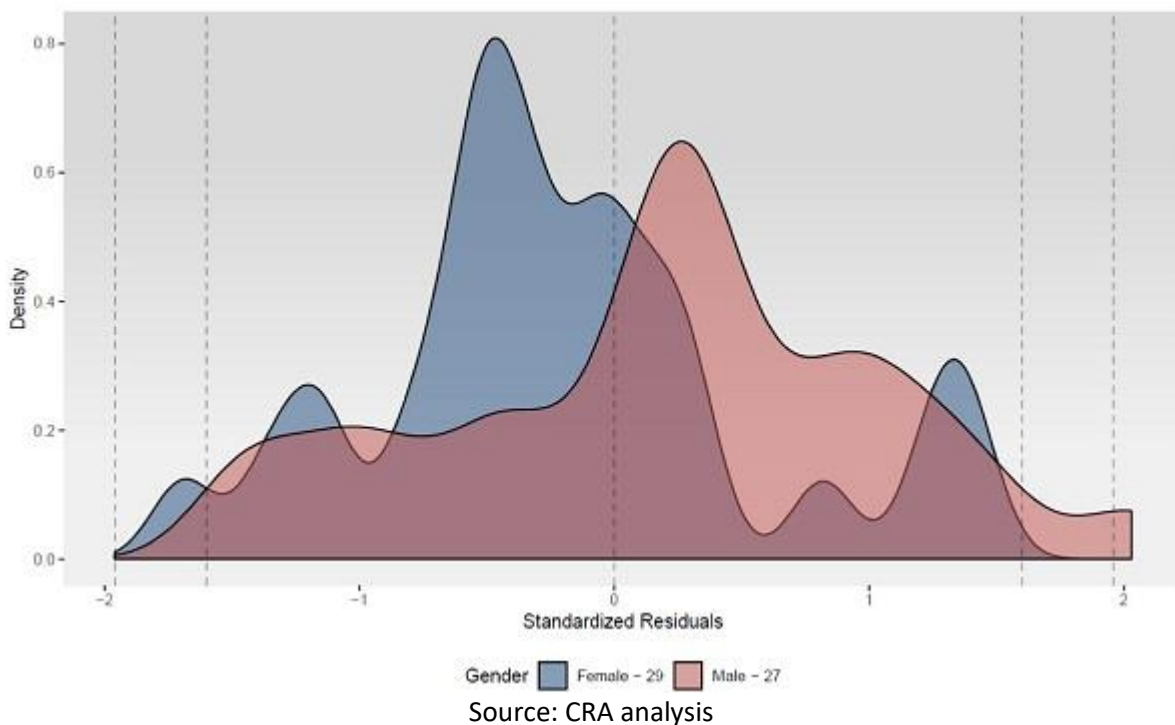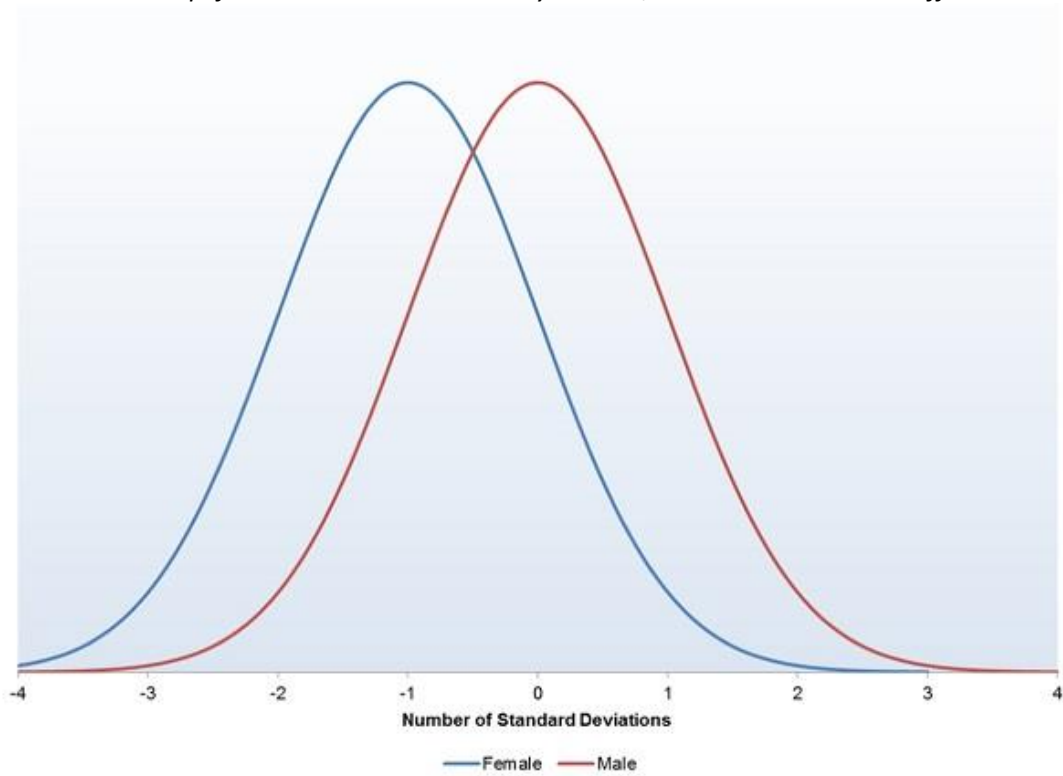

Source: CRA analysis

Chart 3 provides a simplified version of the data shown in Chart 2. The female pay distribution, illustrated with the blue curve, is shifted to the left of the male pay distribution which is represented by the red curve.
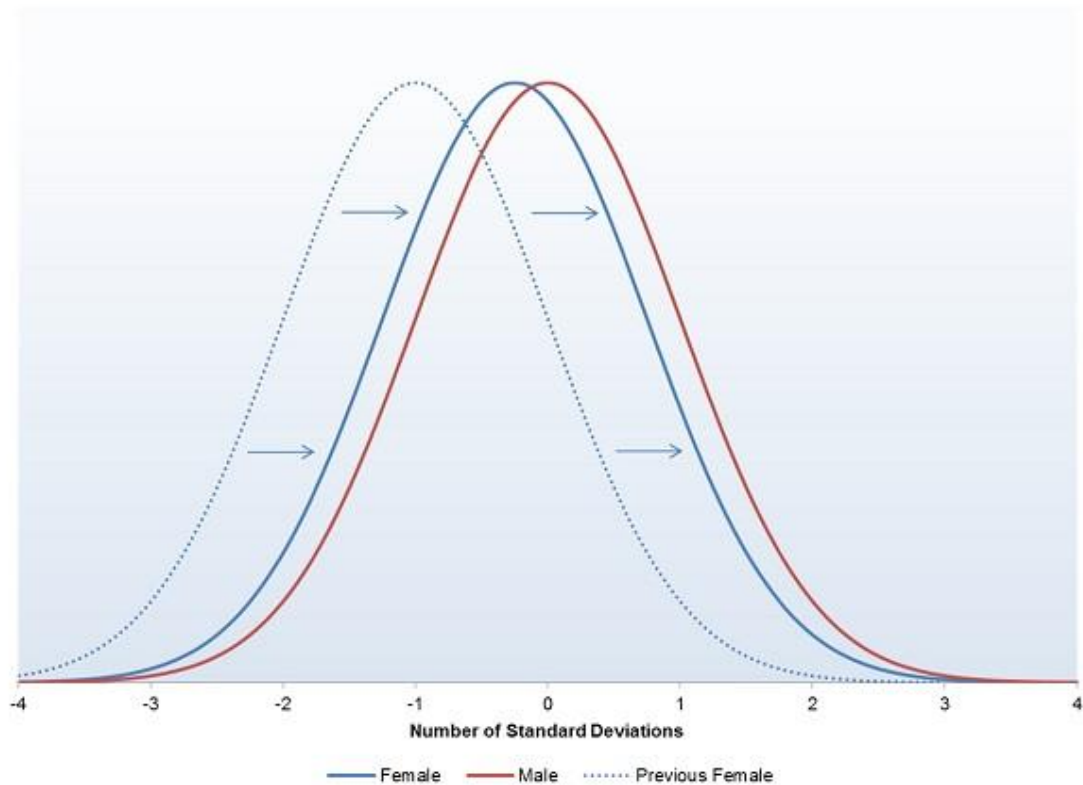
Chart 3: Simplified Residual Distribution by Gender, General Distribution Difference

Number of Standard Deviations

—Female —Male

Source: CRA analysis

The so-called "peanut butter approach" spreads the mitigation budget evenly across the entire target population, with the goal of shifting the entire population into better alignment with the comparison group. Chart 4 illustrates what the peanut butter approach might do to the scenario depicted in Chart 3.

Chart 4: Results of the Peanut Butter Approach on Residual Distribution by Gender

Number of Standard Deviations

——Female ——Male ········ Previous Female

Source: CRA analysis

The peanut butter approach is often seen in class action settlements, where a simple, easy-to-apply solution is preferred. Note that this approach does not alter the variance of the female population — it makes no changes to the overall width of the female pay curve.
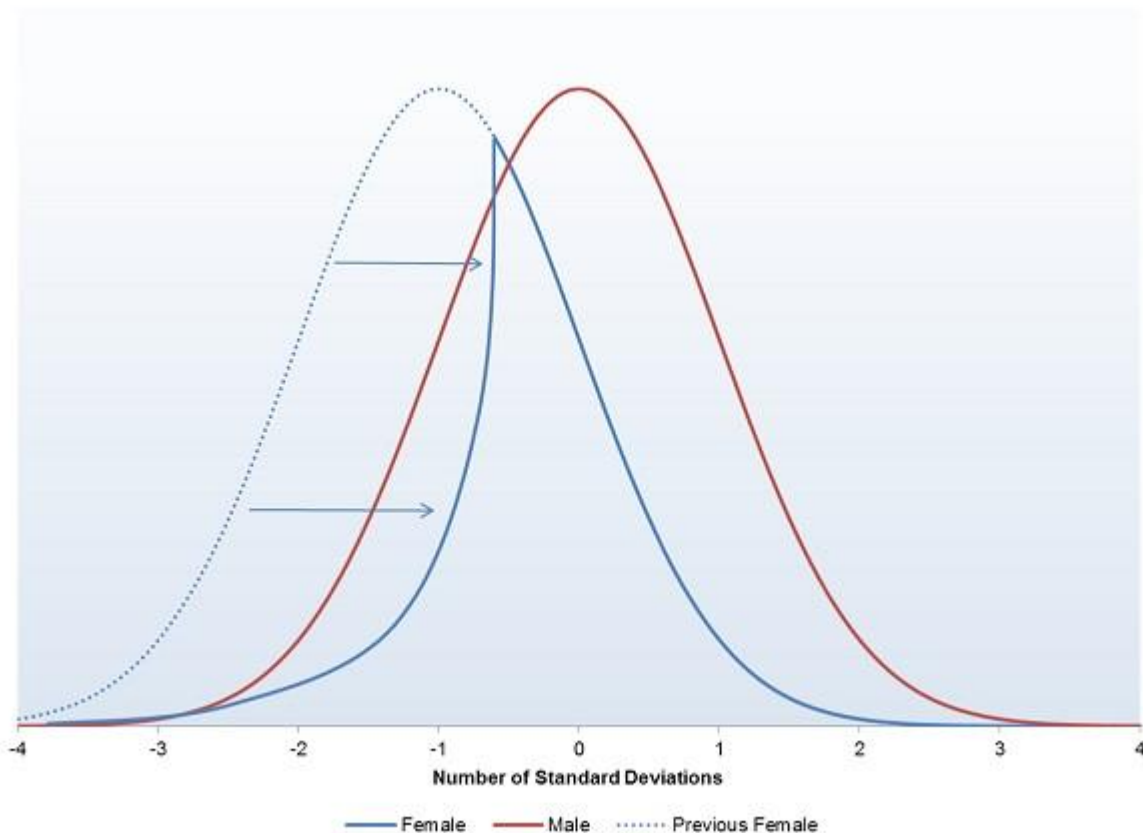
A downside of the peanut butter approach is that it results in increases in pay to the top-compensated women at the company, even though they may not be significantly underpaid. Further, this approach rewards individuals who may be underpaid for a legitimate reason. These changes are more likely to be undone in future salary adjustments. If a fixed percentage adjustment is used (e.g., all women receive an adjustment 1.5% of their base salary), this method is advantageous because within the female population, the relative pay relationships are preserved.

One case where the peanut butter approach may make sense is in the retail context, where a large population of store managers is found to have a small but statistically significant pay gap. In the case of a small gap affecting a large group, spreading the budget over the whole population may be the simplest and most cost-effective solution. If the individual adjustments are small relative to the salary, then an individual review of the equity adjustments would likely not add much value, especially considering the time and effort required.

4. Adjustments Only to "Underpaid" Employees

One way to avoid the problem of overpaying highly compensated members of the target group is to only increase pay of employees who are found to be below the model's predicted pay. Chart 5 illustrates the results of this approach.

Chart 5: Effect of Mitigation Targeting Population Below Predicted Salary

Source: CRA analysis

Employers that do not opt to increase the pay of women paid more than the model predicts often limit adjustments to women paid less than the model predicts. When compared to the peanut butter

approach, the more targeted solution results in the budget being used to target a smaller group of employees. The more highly compensated members of the group are generally excluded. On average this results in a bigger adjustment per employee. In some cases this can result in large pay increases for some employees, requiring employers to spread out the increase over a number of years.

A common but unintended consequence of this approach is leapfrogging, where employees who were low on the distribution are adjusted out of sync with what may have been justifiably lower wages. This result is more likely to occur if the employer lacks the resources to conduct an analysis at an individual level, but instead needs to apply a systematic solution across a broad group.

This approach puts a lot of faith in the accuracy of the pay model. To work, the model needs to correctly capture the data for the studied population. Without adequate information or implementation resources, the women who began at the low end of the distribution in Chart 5 might end up more highly paid than the men with whom they should be at parity.

The solid blue line in Chart 5 shows how raising only the bottom end of the scale results in a tightened variance structure (less variation means the model will be better at predicting salaries). Going forward, such a structure makes the affected population more likely to have statistically significant pay differences.

5. Model Equity Adjustments Using Market Pay Range and Performance

Many employers utilize market data to ensure they are competitively paying employees and to set bounds on manager discretion. Market pay ranges are often used in the merit increase process, with adjustments in part determined according to how far into the market range an employee has penetrated. Chart 6 illustrates a hypothetical increase matrix that intersects position in the market pay range and performance.

Chart 6: Hypothetical Merit- and Market-Based Pay Adjustment Structure

Performance Rating	Bottom 25% of Market Range	26%-50% of Market Range	51%-75% of Market Range	Above 75% of Market Range
Exceptional	3.0%	2.5%	2.0%	0.0%
Very Strong	2.5%	2.0%	1.5%	0.0%
Strong	1.5%	1.0%	0.5%	0.0%
Needs Improvement	1.0%	0.5%	0.0%	0.0%
Too New or Not Rated	0.0%	0.0%	0.0%	0.0%

Source: CRA analysis

Adjustments get smaller as an employee approaches the top end of the market range (moving left to right across the matrix); and, employees with better performance receive larger adjustments (moving up vertically within the matrix). This framework allows for top performers who came in with a lower salary

to catch up quickly. It also applies the brakes to salary growth as employees become more tenured in their position.

The magnitude of the adjustment does need to be scaled to the size of the group difference measured by the model. As such, this method is technically more complex to execute. Use of this method requires that employers maintain current market pay data (preferably for each job title) and use an ordinal performance rating system. The employer would be prudent to confirm the performance ratings are not subject to the same bias that may be involved in setting pay.

Government agencies and plaintiffs are quick to allege that performance ratings are tainted because the same decision makers who set pay are often making the performance evaluations. Any employer that wishes to include performance in their pay model or use performance in the pay-setting process should conduct a performance validation study to confirm that gender and race/ethnicity are not determinants of the performance outcomes.

This approach appeals to employers that want a strategy that aligns with their pay-for-performance compensation philosophy. This strategy is also desirable because it helps preserve the relative pay relationships because on a percentage basis it spreads the budget across the majority of the group using factors already applied by managers in the merit process.

Final Thoughts on Pay Equity Mitigation

In practice, an employer's mitigation strategy is often a combination of multiple techniques. Regardless of the approach that an employer determines is the right fit for its circumstances, a number of important decisions often need to be made during the mitigation process.

Should poor performers be eligible for increases? Should pay increases be capped at a certain level? Should increases be incorporated into the existing merit increase cycle to reduce the mitigation effort's visibility? Should adjustments be done at once or spread over a number of years? The answers to questions like these often need to come from several places within a company. Reaching consensus about goals can be important for getting everyone pulling in the same direction.

Once the employer selects and implements a mitigation strategy it needs to rerun the pay model to confirm that the proposed pay of all employees accomplishes the goals of the project and did not introduce new, unexpected problems in populations that were not targeted. The new pay audit needs to be based on accurate, current data that reflects any recent changes, like promotions, acquisitions, reorganizations or departures that could have significant effects on the analysis.

Employers should view the pay audit and mitigation process as an opportunity to learn. The process can provide valuable insights into a company's pay structure and management culture. It can reveal underlying causes for underpayment, policies that may need review for compliance and best practices, and areas where managers need further training. It also can reveal new strategies the employer might take to reduce the influence of past decisions and avoid those historical policies and practices that contributed to the pay differences.

Quenton Kincaid Wright is a principal in the labor and employment practice at Charles River Associates.

[1] For clarity purposes this article simplifies a myriad of mitigation strategies used by employers of varying sizes, operating in different industries. The information contained within should not be used to prescribe one particular strategy because an effective plan should be tailored to the employer's circumstances using the expertise of a labor economist and counsel.

[2] See Hazelwood School District v. United States, 433 U.S. 299 (1977).