

**Business Ethics**  
**BUS 300**

**Kennedy**

**Notes on Compensation**  
**(revised October 1998)**

Markets and Compensation Justice

One of the principal goals of a sound compensation structure in an organization should be real fairness, or justice, in compensation throughout the organization, not merely the appearance of fairness. Organizations may have several legitimate reasons for keeping compensation information confidential, but preserving confidentiality so as to conceal unfairness is highly questionable. Establishing justice in compensation, however, is one of the quiet, but more difficult, ethical problems that organizations face.

If we speak in terms of justice, as we should, a price represents an estimate of value in exchange. The parties to the exchange engage in the exchange only if they are both/all convinced that they receive in value at least much as they surrender. The problem with compensation is that there is often a misunderstanding about what exactly is exchanged. In fact, it is probably better not to speak of it as an exchange at all, but rather as a voluntary relationship, some aspects of which resemble an exchange. Employees enter into a relationship in which they promise to contribute a significant portion of their productive energies and in response receive compensation (the use of just this word is highly significant) commensurate in some way with the value created by their efforts. An important element to be understood here is that the employees “surrender” their productive energy (and time, creativity, strength, etc) and so cannot use it for another purpose. What is especially important is that they may have nothing else with which to earn a living, and so these productive energies are truly precious to them. The opportunity cost of choosing one employer over another can have drastic consequences which affect not only the employees’s possessions, but potentially the employees’s very lives and the lives of their families.

Wages, salaries and other forms of compensation are, strictly speaking, not prices, nor are markets the mechanical determiners of justice with respect to compensation in the same way that they might be with respect to prices. Properly functioning compensation markets might still produce injustices. Nevertheless, markets do have a role to play in setting levels of compensation because, as in the case of prices, wages and salaries are not susceptible in practice to precise calculations and because skills and knowledge can be scarce resources whose distribution and use may sometimes be well apportioned by markets. Markets may function well to calculate the practical value of the contribution of employees so long as certain principles, or tests, are not violated. Markets should not be a

substitute for the careful consideration of what fairness requires in concrete situations.

## Definitions

Compensation—the set of all benefits properly due to an employee from his employer or as a direct result of his employment.

Employment is a voluntary relationship in which the employee promises to contribute a significant portion of his productive energies toward the achievement of the objectives of another person or organization, and for which contribution the employee receives something of value commensurate with the value created by his efforts. We use the word “compensation” because the employee forgoes opportunities to use his energies for other purposes, whether or not these other purposes create economic value.

Ordinary employee—a properly qualified employee working full-time (# hours per week, # weeks per year) in a non-entry level position and expecting to support himself and his family from his earnings.

Extraordinary employee—an employee in a normally part-time or temporary position, or an employee who lacks the minimum skills usually required for permanent employment, or an employee not expecting to support himself from his earnings.

Entry-level position—a temporary position, full- or part-time, intended in part to be a training experience, for which the employees usually hired lack the skills required for more demanding positions in the organization, and from which these employees are usually promoted once they have acquired the necessary skills.

A menial, unskilled job which provides no opportunity for the acquisition of job skills and from which employees are seldom promoted to better jobs is not an entry-level position.

## Components

- Salary/wage
  
- Benefits (often about 40% of total compensation)
  - vacation
  - pension & retirement benefits
  - insurance
  
- Ordinary subsidies and perquisites (“perks”)
  - child care (flexible time and on-site day care)
  - sick leave
  - family leave

- subsidized purchases (stocks, products and services)
- educational subsidies (employee and family)

- Extraordinary subsidies and perquisites

- cars
- sabbaticals
- stock options & loans
- personal services

- Extraordinary compensation

- bonus (bonuses quickly become expected as part of regular compensation)
- gifts (travel, etc)

### Fairness in Compensation

#### Three Different Levels of Compensation

1. Threshold compensation (fair minimum, “living wage”)
2. Fair compensation (above the threshold)
3. Excessive compensation (“executive compensation”)

The Dignity Test: Does the compensation provided to an ordinary employee respect the dignity of the employee as a person? Is it sufficient, at minimum, to support a decent human life for the employee and his/her family? Is it commensurate with the employee’s position and responsibilities in the community?

The Contribution Test: Is the compensation received by an employee commensurate with the value received by the organization as a result of that employee’s contribution to the activities of the organization?

(1) This principle ordinarily governs the calculation of compensation insofar as it does not lead to the violation of the Principle of Dignity, the Principle of Equity, or the Principle of Non-Exploitation.

(2) This does not mean that all value created by the employee belongs to the employee, or that some “surplus” value may not fairly be kept by the organization. In other words, there should be a reasonable proportion between the value added to an organization and the compensation paid, but this would not ordinarily be an equation of the two.

(3) Extraordinary contributions need not be rewarded through compensation, but might be rewarded through bonuses, promotions or other extraordinary benefits.

The Equity Test: Do employees making similar contributions to the organization receive similar levels of compensation?

Note: This test is to be applied within an organization and not between organizations. Some organizations have greater resources than others and may fairly pay their employees at a higher rate, but this higher rate does not necessarily establish a benchmark

for justice between organizations who are otherwise abiding by these principles. Indeed, a poorly managed organization may not pay its employees well, but this does not mean that it necessarily pays them unfairly. (The managers of such an organization, however, may fail in their duty to employees to the extent that they manage badly, and in that sense do them an injustice.)

The Non-Exploitation Test: Do employers take advantage of the distress of employees to reduce compensation? Do they intentionally create conditions of employment designed to limit the levels of compensation owed to employees? Do employees force employers to pay unusually high levels of compensation out of fear of lost value?

(1) Exploitative conditions of employment could include part-time or temporary positions, or positions in which employees are purposely underemployed or underutilized.

(2) Levels of compensation that are not a result of free negotiations between employee and employer may be exploitative to the extent that the employer takes advantage of his relative freedom to hire an alternate employee and of the employee's relative lack of freedom to find another employer easily.

(3) Employees may exploit employers by threatening action that will result in costly damage to the business, or by threatening to leave at a vulnerable time or if they are in particularly sensitive positions.

The Sustainability Test: Would paying an objectively fair level of compensation (e.g., something more than minimum fair compensation as defined by the Dignity Test) threaten the short-term stability or survival of the organization?

Recognizing the conditions that would justify paying employees something less than fair minimum compensation requires an honest judgment on the part of the employer that the continued stability of the organization would genuinely be jeopardized if a fair wage were to be paid. However, at least three other conditions must also be present:

(1) the burden of reduced or inadequate compensation must be fairly distributed, which means that everyone in the organization should share the burden and that it should fall more heavily on those with higher compensation levels,

(2) the inadequacy of resources is honestly judged to be temporary, and

(3) there is a sincere commitment to compensate employees later for their sacrifices.

Furthermore, on the principle that "half a loaf is better than none," in times of crisis or depression, where the economy in general is in poor condition, employers should distribute fairly whatever resources are available from their operations, even if they fall below fair minimum compensation. In doing so, they incur no further obligation for supplementary compensation as conditions improve.

The second point here is critically important. If the inadequacy of the organization's resources can be honestly judged to be permanent, then paying employees unfairly low levels of compensation is probably not justified. By the same token, in a startup or in a crisis, employees might reasonably be expected to work very long hours, or to work in relatively poor conditions, or with marginal equipment, if enduring such conditions could really help the organization return to "normal." However, if the design of the organization is such that a level of profitability that would remedy these problems can never be expected, then the organization should probably close its doors.