Paycheck Fairness and Market Failure

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Nancy Folbre
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Republicans have successfully shoved the Paycheck Fairness Act back into the closet, but it will eventually pop out again, possibly taking some hinges with it.

The debate over this proposed legislation reveals serious flaws in reasoning about the impact of public efforts to promote fair pay. Recent academic research suggests that many women are underpaid for the same reason that many chief executives may be overpaid — because the labor market doesn't work according to the standard textbook model based on impersonal forces of supply and demand.

The Paycheck Fairness Act would have required employers to give a "business" reason for paying men and women different wages for equal work. It would also have prohibited retaliation against employees who revealed wage information.

Criticisms of the proposed legislation took several forms. A common claim was that it would do more harm than good, because pay discrimination is not the most important cause of gender disparities. Conservatives are not the only ones who insist that women are paid less primarily because they choose to devote more time to family responsibilities than men do. The New York Times columnist Eduardo Porter recently articulated a similar argument.

But pay discrimination and choices to take time out of paid employment are complementary rather than competing explanations of gender differences in pay. Women who are paid less — or who anticipate fewer opportunities for promotion — than their male counterparts are more likely to drop out of paid employment. Their choices represent, in part, a response to discrimination.

If a woman does drop out for a while, an employer who pays her less is off the hook. Case law shows that a lower level of experience on the job is typically considered a bona fide "business" reason for paying someone less. In her discerning analysis of the impact of the Equal Pay Act passed in 1963, a University of Maryland law professor, Deborah Thompson Eisenberg, points out that the Paycheck Fairness Act would have simply codified majority interpretations of that law.

Is justifying pay differences between men and women doing substantially the same job an expensive and onerous regulatory requirement? Not for businesses with reasonable pay and hiring guidelines. Professor Eisenberg points out that I.B.M. conducts annual audits of the base pay of women and minorities relative to other workers, asking managers to explain any large discrepancies.

A second, even more influential criticism of the Paycheck Fairness Act holds that "the market knows best." By this account, interference with the forces of supply and demand will reduce overall efficiency. Much depends on how efficiency is defined.

Even if only a few employers discriminate, this lowers women's average market wages, reproducing gender inequality at nondiscriminating firms. As an employer might put it, "We're only paying you less because you were paid less in your previous job."

Standard economic reasoning suggests that employers should recognize that women are a really good deal precisely because they can be paid less. The increased demand for relatively cheap but equally productive women should bid their wages up to the same level as men. Market forces should promote increased fairness along with increased efficiency.

But hiring probably doesn't work this way, for reasons beautifully summarized by Professor Eisenberg in another article, titled "Money, Sex, and Sunshine: A Market-Based Approach to Pay Discrimination." Many jobs in today's economy — particularly those at the higher occupational levels where gender differences in pay are most pronounced — are not standardized, and wage rates are not determined by a market based on open bidding.

Big discrepancies in pay across companies are common. Since information about wages is proprietary and typically a secret, employers often can't assess the market wage. Further, workers can't get the information they need to bargain effectively or ensure they're being treated fairly.

Professor Eisenberg argues that pay secrecy helps explain why the salaries of chief executives have skyrocketed in recent years. Drawing on research by Lucian Bebchuk and Jesse Fried, summarized in their book "Pay Without Performance," she points out that institutional arrangements — such as the structure of corporate boards — influence chief executive compensation more than the forces of supply and demand.

Board members are often reluctant to challenge the pay demands of chief executives, who exercise considerable influence over board membership and remuneration. The invisible handshake pre-empts the invisible hand of market competition.

In this case shareholders, rather than employees, bear the brunt of market failure. Like Lilly Ledbetter, who didn't learn that she had been paid less than her male counterparts until she received an anonymous letter on retirement, many shareholders have found it hard to challenge chief executive pay. Now, thanks in part to new regulatory requirements for pay transparency, shareholder activism is on the rise.

Professor Eisenberg emphasizes that efforts to promote pay transparency in all jobs should extend beyond the legislative arena and that companies as well as their employees would benefit.

More broadly, she suggests that the legal quest for equal pay should look beyond efforts to punish intentional discrimination and discourage hiring and pay practices that may be unintentionally problematic.

Through that wide door, the issue of paycheck fairness could re-enter the political agenda in bigger, stronger form.