

The Impact of Pay Satisfaction and Transformational Leadership on Employee Engagement

Devyani Sharma and Venkat R. Krishnan

***Abstract.** Employee engagement is an issue of concern to all organizations and they adopt monetary as well as non monetary methods to achieve the same. This paper studies the impact of pay satisfaction and transformational leadership on employee engagement. Data was collected from 93 respondents across domains. Analysis of the findings showed that transformational leadership is a significant determinant of employee engagement. Transformational leadership was also found to be significantly related to pay satisfaction.*

Firms in today's competitive times are facing talent shortages due to demographic changes in the workforce. Therefore, retaining employees is becoming a key focus area as employee turnover can affect an organization due to the high costs associated with attrition. Organizations are adopting two broad measures to attract and retain talent. Namely, focusing on transactional strategies and attempting to induce employees by material rewards. Also, competitively increasing salaries are evidence of the fact that companies are trying to outdo each other in enticing employees through hefty pay packages. Organizations are also focusing on transformational strategies, such as developing a positive culture through exemplary leadership. Companies following this strategy often invest large sums of money in leadership development, training, and cultural transformation. Though organizations may pursue either of the strategies, there is no empirical evidence as to which strategy is more suitable to enhance organizational commitment and retention.

Theory and Hypotheses

Employee Engagement

According to Markos and Sridevi (2010), employee engagement is one domain of human resource management that is intertwined with almost all aspects of managing human resources. The meaning at work has the potential to be a valuable way of bringing employers and employees closer together to the benefit of both where employees experience a sense of community, the space to be themselves and the opportunity to make a contribution. Employees want to work in the organizations where they find meaning at work. The author has also proven that employers now realize that by focusing on employee engagement, they can create more efficient and productive workforce.

Swaminathan and Rajasekaran (2010) have equated employee engagement as follows:

Motivation + Satisfaction + Effectiveness = Employee Engagement

Sugheir, Coco, and Kaupin (2011) have observed that with the emergence of employee engagement as an important concept have come a plethora of management prescriptions. In their study, 'Employee Engagement as a key to improving performance', Markos and Sridevi (2010), discovered that employers in the current generation do realize that by focusing on employee engagement they can induce better efficiency and productivity among the workforce.

Employee engagement is the involvement with and enthusiasm for work and is affected by several factors including both emotional and rational factors related to work and the overall work experience.

Markos and Sridevi (2010) have provided a broader definition of the same which focuses on the attitude of the employees towards the work and have highlighted the significance of the employer – employee relationship in achieving the same. According to them, "an engaged employee is aware of business context, and works with colleagues to improve performance within the job for the benefit of the organization. The organization must work to develop and nurture engagement, which requires a two-way relationship between employer and employee."

Evolution of engagement. Engagement is about passion and commitment. It is the willingness to invest oneself and expand one's discretionary effort to help the employer succeed, which is beyond simple satisfaction with the employment arrangement or basic loyalty to the employer. Thus, the complete equation of engagement is obtained by aligning maximum job satisfaction and maximum job contribution.

Attridge (2009) has suggested the use of individual level scores that can be aggregated to measure engagement at the individual or group level. Several surveys are conducted by global survey houses for measuring engagement across various parameters. However, the shortcoming of the same is the validity of the parameters across sectors and divisions and also the weight each parameter carries. In fact, if all available literature on engagement is considered, the factors measured vary to the extent that it seems that different constructs are being measured. (Ellis & Sorenson, 2007)

Drivers of employee engagement. Maslow's need hierarchy model can be looked at from an organizational point of view as a hierarchy of engagement. The base of the pyramid is basic needs and it tapers to the top as security needs, social needs, esteem needs and self actualization. According to Luthans (2011), the aforementioned can be substituted with pay, insurance and pension, formal and informal work groups and teams, status and realization of potential respectively (p.164). Once the aspirations cited at the base of the pyramid are fulfilled, the employee looks up to an alignment of value-meaning, which is displayed by a true sense of connection, a common purpose and a shared sense of meaning at work.

Markos and Sridevi (2010) have also demonstrated empirical evidence of the five aspects a manager must heed to achieve enhanced employee engagement. They are: aligning efforts with strategy, empowerment, promoting and encouraging teamwork and collaboration, helping people grow and develop and providing support and recognition to employees.

According to Vance (2005), employee engagement is the outcome of personal attributes as knowledge, skills, abilities, temperament, attitudes and personality; and organizational context which encompasses leadership and social setting; and finally human resource practices that directly affect the person, process and context components of job satisfaction (p.9). Markos and Sridevi (2010) found in their study on engagement that most drivers that are found to lead to employee engagement are non-financial in nature, which

pertains to the hypothesis of the study that employee engagement is positively related to pay satisfaction.

Employee engagement and organizational performance. Customer satisfaction relates to retention, productivity, profitability and customer loyalty; and engagement is positively related to customer satisfaction as proved in the study by Markos and Sridevi (2010).

Engaged employees consistently demonstrate three general behaviors which improve organizational performance which are say, stay and strive. ‘Say’ focuses on how the employee advocates for the organization to co-workers, and refers potential employees and customers. ‘Stay’ talks about how an employee has an intense desire to be a member of the organization despite opportunities to work elsewhere while ‘strive’ throws light on how the employee exerts extra time, effort and initiative to contribute to the success of the business (Baumruk & Gorman, 2006).

Employee engagement strategies. The strategies can be divided into monetary and non-monetary. The monetary strategies include the compensation and benefits package offered to employees. The non-monetary ones pertain to an effective recruitment and training program, leading by example, an enhanced communication channel, satisfactory opportunities, a strong feedback system and building conducive work environment and culture; as indicated by Markos and Sridevi (2010). Also, according to Guo and Burton (2010), previous studies have generally found the benefit elasticity of workers’ compensation cash benefits to be greater than 1.0.

The literatures thus indicate that employee engagement has a close linkage with organizational performance outcomes. Companies with engaged employees have higher employee retention as a result of reduced turnover and reduced intention to leave the company, productivity, profitability, growth and customer satisfaction. On the flip side, companies with disengaged employees suffer from futile effort put behind breeding talent, and earn less commitment from the employees, face increased absenteeism and have less customer orientation and productivity, and reduced operating margins and thus low net profit margins.

Hypothesis 1. Employee engagement is positively related to pay satisfaction.

Pay Satisfaction – Compensation and Benefits

Direct compensation refers to any reward, usually in cash and stock, given in direct proportion to performance. Indirect compensation is not related to performance and is given in the form of various benefits.

According to Jawahar and Stone (2010), perceived satisfaction of pay, the procedures used to make compensation related decisions, and the manner in which compensation related information is communicated play an integral role in shaping reactions to critical elements of the compensation system.

The components of compensation and the CTC (cost to company) composition is described below:

- A. Annual Base Salary
- B. Cash Allowances
- C. Guaranteed Bonus
- D. Guaranteed Cash Compensation ($D = A+B+C$)

E. Total Benefits

F. Total Package ($F = D+E$)

G. Total Variable Bonus

H. Total Cost to Company ($H = F+G$)

Compensation encompasses two broad frameworks namely fixed pay (basic salary and fixed allowances) and variable pay (incentives, bonus, profit-sharing).

Compensation strategy, external competitiveness or benchmarks, internal consistency, rewards and referrals, job analysis and evaluation, and performance management are the various factors that affect pay structures. A compensation plan, however, must be legal apart from serving various corporate purposes and meeting employee needs.

According to Purushotham (2009), the internal factors that affect pay (and thus affect satisfaction) are leadership, culture, employee demographics, affordability and business cycle.

Schiemann (1987) found in his study that employee morale can be hurt by pay cuts because the employees view this as an insult that impacts their self worth and value to the organization.

The traditional methods of administering pay are the base pay approach and the merit pay approach. Base pay is often determined by market conditions and also according to the benchmarks and trends prevalent in the industry. Gaughan, Jorg, John, and Jeff (2000) have also substantiated the same regarding following market trends. If the base pay is not in accordance to the market rate, organizations may find that they are unable to attract and retain talent.

The merit pay approach ensures pay for performance. However, it comes with its inevitable shortcomings as the criteria for determining merit (which are often nebulous) since organizations don't clearly spell out the conditions for earning that pay. Another criterion is the difficulty in quantifying the merit pay. A second major drawback is that the merit pay can end up being the 'catch-up' pay as a cover up for the differentials to the market median. There are two kinds of 'pay for performance' plans namely individual incentive plans and group incentive plans. However, according to Hansen (2007), it's still not very prevalent.

Under the individual incentive plan, an individual has the opportunity to earn as much as 50% more than his counterparts. These plans include the piece rate and time rate wage systems. Bonuses and stock options are yet another form of providing individual incentives. A signing bonus is the biggest incentive for upper level managers.

Another form of individual incentive pay is stock options. The primary idea behind a stock option plan is that if the executives are successful in their efforts to increase organizational performance, the value of the company's stocks will also rise. (Brandes, Dharwadkar, & Lemesis, 2003). Group incentive plans are a commonly adopted gain sharing plan.

Luthans (2011) identified the new emerging pay approaches as commissions beyond sales to customers, rewarding leadership effectiveness, rewarding new goals pay for knowledge workers in teams, skill pay, competency pay and broad-banding. (p. 343)

Apart from compensation, benefits form a part of the cost to company in any individual's package. The various types of benefits offered include leave travel, retirement benefits, housing and accommodation benefits, loans, and entertainment benefits as club

membership. According to Klein (2007), employees can be overwhelmed with a variety of healthcare and retirement options offered to them.

The more an employee is aware of the compensation structure and his pay design the more is his propensity to judge his package justly. Sweins, Kalmi, and Nyman (2009), have stated that higher levels of pay knowledge are associated with improved pay satisfaction and perceived pay effectiveness at the organizational level.

Employee attitude towards compensation and benefits. According to the results from focused group discussions, more employees expect to see pay increases that are conditional to performance and organizations face challenges in designing a performance appraisal system. Recent data (Schiemann, 2010) on this subject indicate that 31% of managers, 34% of professionals, and 39% of hourly employees rate their performance appraisal process as either "not too" or "not at all" effective.

Day (2011) has propounded in her study that when workers receive pay communication they feel more fairly treated; which also brings in the role of the manager or the leader in picture. We thus hypothesize the role of a charismatic leader in inducing pay satisfaction.

Hypothesis 2. Pay satisfaction is positively related to transformational leadership.

Transformational Leadership

Leadership is one of the most researched topics in the field of organizational behavior. A lot of research has been conducted on the different styles of leadership and many theories have been proposed. However it is a daunting task to come up with a perfectly descriptive definition of the same. Leadership is the process of influencing a group towards the achievements of goals and a leader as someone who can influence others and who has managerial authority.

The modern theories of leadership include charismatic leadership and transformational leadership. The term Transformational Leadership was introduced in 1978 by James MacGregor Burns in his analysis of political leaders. He proposed two basic concepts of leadership: 'transformational' and 'transactional' leadership (Bass, 1997).

Transformational leaders take strategic decisions and give shape changes, thereby ensuring that their organizations stay competitive. While the core of transformational leadership is universal, timeless and immanent, its behavioral manifestations, however, differ across cultures.

Transformational Leadership as an area of study is a recent development and of great interest in the dynamic world. Thus the need for leaders who will guide an organization along the path of transformation is imperative in the 21st century. To achieve success in today's day, organizations need leaders who are willing to change the status quo, to envision new horizons, and lead by example to motivate their teams to achieve their goals. Singh and Krishnan (2005) have observed transformational leadership as leading change.

Combining past research on positive moods with the present findings, it is also suggested that an employees' positive mood is one of the important variables in leadership that should not be ignored. (Tsai, Chen, & Cheng, 2009).

According to Bass (1997), transformational leadership has four dimensions – idealized influence or charisma, inspirational motivation, intellectual stimulation, and individualized consideration. Idealized influence refers to the extent to which the leader's followers emulate them and seek to personally identify with them. Inspirational motivation is

a leader's ability to motivate, energize and inspire their followers by communicating a positive vision of the future. Intellectual stimulation refers to a transformational leader's ability to encourage and inspire their followers to use their own potential. Individualized consideration refers to a leader's receptiveness and sensitivity to their followers' needs for growth, support and achievement. Satisfied subordinates are likely to perform better and improved transformational leadership can increase organizational effectiveness. (Hassan, Fuwad, & Rauf, 2010)

Mulla and Dhawan (2011) noted that in order to retain employees, organizations pursue two kinds of strategies. It has been observed that organizations are focusing on transactional strategies and attempting to lure and retain employees by material rewards. Salter *et al.* (2010), point out that transformational leaders create higher productivity in organizations than transactional leaders do. Second, organizations are focusing on transformational strategies, such as developing a positive culture through exemplary leadership. Companies adopting this strategy invest hugely in leadership development, training, and cultural transformation. While organizations may pursue one or the other, or a mix of both strategies, there are no clear measurable guidelines as to which strategy is more suitable to enhance organizational commitment and retention. It is thus hypothesized that pay satisfaction and transformational leadership impact employee engagement.

Transformational leadership leads to the identification of followers with the organization. In addition, transformational leadership leads to better affective commitment, that is, the emotional identification and engagement with organizational unit of the follower. It can be seen that the results of long relationship duration can also be obtained by having deep and intense relationship between the leader and the follower. Transformational leader develops deep relationship with followers by addressing their moral development and influences their value systems rather than just fulfilling transactional needs.

Pay satisfaction, understanding of pay plan, and belief in pay plan effectiveness have correlated positively with affective based organizational commitment (Dulebohn, & Martocchio, 1998). Pay satisfaction is related to overall job satisfaction, motivation, and performance. Pay satisfaction levels are also associated with absenteeism and turnover rates.

Organizations attend to four forms of equity in designing their pay systems: external equity, internal equity, individual equity, and procedural equity. Each of these has an important role to play as a predictor of pay satisfaction (Terpstra, David, Honorée & Andre, 2003). Meta-analytic results have shown that pay satisfaction is related to turnover intentions, absenteeism, and voluntary turnover (Williams, McDaniel & Nguyen, 2006).

Paarlberg and Lavigna (2010) noted that over the last two decades, a growing body of research has supported a positive relationship between transformational leadership and various measures of employee performance and satisfaction in both private and public organizations.

Hypothesis 3. Employee engagement is positively related to transformational leadership.

Method

The survey method of data collection has been used for the research study using questionnaires on transformational leadership (Krishnan, 2008), employee engagement – Utrecht scale (Schaufeli, & Bakker, 2003), and pay satisfaction (Heneman, & Schwab, 1985). A five point Likert scale has been used for each question. The transformational leadership scale has particular relevance to the Indian context and has 30 items measuring characteristics

of transformational leadership, namely, idealized influence-attributed, idealized influence-behavior, individualized consideration, intellectual stimulation, and inspirational motivation. The 17 item Utrecht scale measures vigor, dedication and absorption. The pay satisfaction scale measures pay level, benefits, pay raise and, structure and administration in an 18 item questionnaire.

The respondents targeted are those working in multinationals or Indian listed companies. The data thus collected was obtained using an online survey, with a response rate of 40%. As specified in Table 1, the total sample size of 93 comprises of respondents primarily in their twenties with an equitable mix of males and females. The sample was chosen across entrant and junior management levels and belongs primarily to the research and analytics field.

Table 1. Respondent's demographic profile:

Categories	Sub Categories	Data
Median age of respondent		25 years
Median number of years spent in the organization		2.3 years
Median number of years of work experience with the leader		1 year
Managerial level of respondent in the organization	Entrant	75%
	Junior Management	25%
Educational qualification of respondent	Graduate	61%
	Post Graduate	39%
Industry / Domain of work	Consulting	21.50%
	BFSI	15%
	IT / ITES	39%
	Sales & Marketing	5%
	Operations	9.50%
	Other	9.50%

Results

The Cronbach alpha is shown in the bracket for the items measuring transformational leadership (.978), employee engagement (.899) and pay satisfaction (.963). These represent considerably high reliability.

Table 2 presents the means, standard deviations, reliabilities (Cronbach alphas), and correlations between all variables in the study.

Table 2. Correlations Between Variables^a

(N = 93)	M	S.D.	1	2	3	4	5	6	7	8
1. Vigour	3.45	0.69	(0.80)							
2. Dedication	3.49	0.82	**0.63	(0.88)						
3. Absorption	3.47	0.66	**0.57	**0.51	(0.74)					
4. Pay Level	2.87	0.99	0.04	†0.19	-0.03	(0.96)				
5. Benefits	2.86	0.99	-0.04	0.13	-0.06	**0.73	(0.96)			
6. Pay Raise	2.94	0.94	0.12	†0.19	0.11	**0.78	**0.7	(0.86)		
7. Structure & Administration	3.04	0.87	0.17	*0.21	0.02	**0.75	**0.7	**0.78	(0.89)	
8. Transformational Leadership	2.62	0.88	**0.32	**0.39	**0.38	**0.36	*0.24	**0.41	**0.3	(0.98)

^a Alphas are in parentheses along the diagonal.

† = $p < .10$. * = $p < .05$. ** = $p < .01$. *** = $p < .001$.

Regression was conducted using forward method as well as enter method, taking transformational leadership, pay raise, benefits, pay level and, structure and administration as the independent variables. Vigor, dedication and absorption were the dependent variables, regressed one at a time. Transformational leadership was found to be a significant predictor of engagement, that is, of all factors of engagement, namely, absorption, vigor and dedication.

Hypothesis 1 stated that employee engagement is positively related to pay satisfaction. As can be observed from Table 2, there was no significant correlation between pay satisfaction and dedication. However, when the three factors of engagement were regressed on pay satisfaction, vigor was found to be dependent on structure and administration. Thus, hypothesis 1 was partially supported.

Hypothesis 2 stated that pay satisfaction is positively related to transformational leadership. There was found to be significant correlation between the two variables, as described in Table 2. Significant correlation was also found among transformational leadership and each of the separate factors of pay satisfaction, namely, pay level, benefits, pay raise and, structure and administration. Thus, support was found for hypothesis 2.

Hypothesis 3 stated that employee engagement is positively related to transformational leadership. As described in Table 2, significant correlations between transformational leadership and the three factors of engagement namely vigor, dedication and absorption were observed. Hypothesis 3 was thus accepted.

Table 3. Linear Regression

	Dependent Variable	Step	Independent Variable	Parameter Estimate	t	Model R ²	Model F
Forward Method	Vigour	1	Transformational leadership	0.32	**3.23	0.1	**10.36
Enter Method	Vigour		Transformational Leadership	0.33	**3.04	0.17	**3.55
			Benefits	-0.25	-1.6		
			Pay raise	0.01	0.06		
			Struct & admin	0.34	*2.15		
			Pay level	-0.18	-1.03		
Forward Method	Dedication	1	Transformational leadership	0.39	***4.03	0.15	***16.26
Enter Method	Dedication		Transformational leadership	0.38	**3.50	0.16	**3.42
			Benefits	-0.01	-0.08		
			Pay raise	-0.11	-0.57		
			Struct & admin	0.18	1.02		
			Pay level	0.01	0.05		
Forward Method	Absorption	1	Transformational leadership	0.38	***3.96	0.15	***15.63
Enter Method	Absorption		Transformational leadership	0.41	***3.87	0.2	**4.24
			Benefits	-0.13	-0.88		
			Pay raise	0.13	1.22		
			Struct & admin	0	-0.02		
			Pay level	-0.25	-1.42		

* = $p < 0.05$. ** = $p < 0.01$. *** = $p < 0.001$. Struct & admin = Structure & administration

Discussion

Theoretical Contribution

The study offers supporting evidence indicating that transformational leadership style is a significant determinant of employee engagement. The results indicate a significant relationship between transformational leadership and pay satisfaction. This is in agreement with the results of a study by Purushotham (2009) which found that leadership is among the internal factors that affect pay satisfaction, other factors being culture, employee demographics, affordability and business cycle. The results also indicate a significant relationship between transformational leadership and employee engagement. Similar results were reported by Paarlberg and Lavigna (2010). The results indicate that structure and administration of pay are positively related with vigor. The relationship of pay satisfaction could not be established with absorption and dedication, perhaps because the respondent

sample is composed primarily of young entry level employees who do not commit themselves to one particular organization for a very long period of time. This is borne out by the median number of years that the current sample has spent in their present job. That is, the sample has spent 2.3 years in their present job. The results of the study indicate that engagement levels among employees can be enhanced through improved leadership skills among managers.

Managerial Implications

Managers should thus work towards building leadership skills which are transformational and not transactional in nature. Managers should serve as role models to employees for them to be more engaged in the organization. The study also highlights the significance of leadership development and mentorship programs in organizations.

Limitations and Suggestions for Future Research

The findings of the study are based on data collected majorly from IT organizations and may thus be relevant primarily in the IT sector itself. There may also be other variables affecting engagement which have not been highlighted in the study. One constraint of the research has been that 75% of the respondents belong to the junior levels in an organization. The present study has focused on few key variables of pay satisfaction, transformational leadership and other demographic factors such as gender, age, years of experience etc. Another limitation of this study is that it relies on self reported data. Though self reported objective and demographic data is easily verifiable, other information like feelings, attitudes and perceptions are not. Further studies on the subject could include a wider sample sector and also ensure the inclusion of all grades in an organization to minimize error that may arise due to hierarchies.

Conclusion

Employee engagement is critical for any organization and organizations constantly strive to achieve high engagement levels among employees through monetary as well as non-monetary factors.

Analysis of the findings showed that transformational leadership is a significant determinant of employee engagement. Transformational leadership was also found to be significantly related to pay satisfaction. Thus, for organizations to be successful, they need to train leaders on transformational leadership skills, which in turn would help keep employees engaged and satisfied.

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