

PRODUCTIVITY, EMPLOYEE MOTIVATION AND LABOUR MARKET INCENTIVES: INSIGHTS FOR GOVERNMENT POLICY

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IN BRIEF

As personnel economics and employee motivation can have a significant impact on organisational productivity, thoughtful incentives could help promote productivity growth. These might include:

- (i) piece rate pay schemes to encourage effort and self-selection;
- (ii) “tournament”-styled dispersed pay structures to entice excellence; and
- (iii) appropriate team-based compensation and generalist training for leaders and entrepreneurs.

THE RIGHT PAY SCHEME MATTERS: FLAT RATE VS PIECE RATE

When Safelite, a large autoglass producer in the US went from paying an hourly wage basis to a piece rate basis, they experienced a **44%** increase in productivity. This was a result of both **incentive effects** (average worker efforts went up as a result of output-based payoffs) and **sorting effects** (more ‘productive’ workers were attracted to the piece-rate wage structure, while ‘unproductive’ workers were less likely to participate).

Piece-rate pay is best applied to industries where output and quality can be easily measured.

Output-based pay is less applicable to service and managerial positions. As measurement becomes more accurate and less costly, there can be more variance in pay to strengthen both incentive and sorting effects.

Incentives scale differently at the country level

The sorting effect is useful when considering organisation-based productivity. However, it is less applicable at the national level, where the effect would be limited by the complex and time-consuming process of immigrant self-selection.

‘TOURNAMENT’ INCENTIVES — RELATIVE PERFORMANCE AND PRIZE SPREADS

Where absolute performance is harder to measure, “tournament” incentives might be effective. In tournaments (such as Wimbledon for tennis) prize spreads are large — **the winner receives much more than everyone else**. Because “winning” is based on **relative performance**, all contestants (such as employees competing for promotions) are motivated to excel. In the business world, CEO salaries are high not to reflect the CEO’s output level *per se*, but rather to motivate individuals competing to be the CEO to work harder.

Right-sizing the tournament prize to motivate

The ‘tournament’ prize in the working world (e.g. becoming the Chief Executive) must be relatively attractive and large enough to motivate contestants to excel. However, in a competitive labour market, ‘prize spreads’ that are **too** large may be counterproductive — as everyone becomes unbearably competitive, the baseline level of effort required becomes so high that few would want to work there in the first place.

The riskier the industry, the larger the spread has to be

This is because success depends more on exogenous factors (e.g. luck) and relatively less on individual effort. The same applies to new industries: to offset the relative risk of entering a new industry (relative to traditional jobs), people have to be enticed by the larger ‘prize spreads’ and potential wage jump.

It matters how contestants are grouped

Employees will be less motivated if their competing group is defined either **too broadly**, because individual efforts are less likely to affect their chances for advancement, or **too narrowly**, since they will know with greater certainty whether or not they will be promoted.

Make sure the contest isn't rigged

Corruption and nepotism are bad for tournaments. If competitors already know who is going to win in advance, it kills off motivation and effort for **everyone** in the running — both for the 'winners' who knows they are going to win, and for everyone else who do not feel they have a fair chance to get ahead.

After-tax income is what counts

To support strong work incentives, the government should ensure large **after-tax compensation**, which is what is relevant to people. A flat tax structure is likely to strengthen work incentives; conversely, progressive taxation may reduce the motivation to work harder and advance.

TEAMS ARE NOT ALWAYS BETTER

Artificial Teams: The Puzzle of Levis Strauss

Creating an artificial team environment to perform what is essentially an individual task may hurt, rather than help, productivity. In the 1990s, Levi Strauss and Co. tried to improve workplace relations by putting workers in arbitrary teams and paying them on the basis of team output — with disastrous results. Previously, individual workers had been paid for making jeans by themselves; when they were put into teams, the individual nature of the work did not change but they now had to share the rewards among a team, not all of whom were pulling their weight.

So when are teams useful?

Teams are useful when the production of one worker complements that of his co-worker. For example, in complex environments (e.g. biotech industry) no one person can know or do everything, and it is part of the work process for different people to collaborate towards shared goals.

LEADERS AND ENTREPREUERS ARE GENERALISTS, NOT SPECIALISTS

Data suggests that both entrepreneurs and leaders of organisations are more likely to have been in many roles during their professional careers, and done a generalised programme during graduate school. They are generalists relative to their peers, able to see a broad spectrum of issues and make the best decisions in a large variety of situations.

Generalist education may encourage entrepreneurship and leadership.

Germany has a specialist, vocational training system which starts very early in life. The US education system is more generalist, allowing students to specialise only at graduate-level. Anecdotally, there is more entrepreneurial activity in the US than in Germany.

CONCLUSION: COULD WAGE INEQUALITY BE A GOOD THING?

Firms often face pressures to compress the wage structure. Most governments face pressures to reduce inequality through progressive taxation. Yet, by increasing wage spreads and after-tax incomes there could be real, positive effects of on productivity and employee motivation. It begs the question: to what extent is maintaining wage and income inequality a good thing?

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