

## Six dangerous myths about pay.

by Jeffrey Pfeffer

**There are six myths about compensation. These myths include that labor rate and labor costs are equated, that lower labor rates will decrease labor costs and that labor costs are a major portion of total costs. The other myths include that people work for money, that performance is improved through individual incentive pay and low labor costs increase a company's competitive edge.**

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Many managers have bought into expensive fictions about compensation. Have you?

Consider the groups of steel minimills. One group pays an average hourly wage of \$18.07. The second pays an average of \$21-52 an hour. Assuming that other direct-employment costs, such as benefits, are the same for the two groups, which group has the higher labor costs?

An airline is seeking to compete in the low-cost, low-frills segment of the U.S. market where, for obvious reasons, labor productivity and efficiency are crucial for competitive success. The company pays virtually no one on the basis of individual merit or performance. Does it stand a chance of success?

A company that operates in an intensely competitive segment of the software industry does not pay its sales force on commission. Nor does it pay individual bonuses or offer stock options or phantom stock, common incentives in an industry heavily dependent on attracting and retaining scarce programming talent. Would you invest in this company?

Every day, organizational leaders confront decisions about pay. Should they adjust the company's compensation system to encourage some set of behaviors? Should they retain consultants to help them implement a performance-based pay system? How large a raise should they authorize?

In general terms, these kinds of questions come down to four decisions about compensation:

- \* how much to pay employees;
- \* how much emphasis to place on financial compensation as a part of the total reward system;
- \* how much emphasis to place on attempting to hold down the rate of pay; and
- \* whether to implement a system of individual incentives to reward differences in performance and productivity and, if so, how much emphasis to place on these incentives.

For leaders, there can be no delegation of these matters. Everyone knows decisions about pay are important. For one thing, they help establish a company's culture by rewarding the business activities, behaviors, and values that senior managers hold dear. Senior management at Quantum, the disk drive manufacturer in Milpitas, California, for example, demonstrates its commitment to teamwork by placing all employees, from the CEO to hourly workers, on the same bonus plan, tracking everyone by the same measure -- in this case, return on total capital.

Compensation is also a concept and practice very much in flux. Compensation is becoming more variable as companies base a greater proportion of it on stock options and bonuses and a smaller proportion on base salary, not only for executives but also for people further and further down the hierarchy. As managers make organization-defining decisions about pay systems, they do so in a shifting landscape while being bombarded with advice about the best routes to stable ground.

Unfortunately, much of that advice is wrong. Indeed, much of the conventional wisdom and public discussion about pay today is misleading, incorrect, or sometimes both at the same time. The result is that businesspeople end up adopting wrongheaded notions about how to pay people and why. They believe in six dangerous myths about pay -- fictions about compensation that have somehow come to be seen as the truth.

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Do you think you have managed to avoid these myths? Let's see how you answered the three questions that open this article. If you said the second set of steel minimills had higher labor costs, you fell into the common trap of confusing labor rates with labor costs. That is Myth #1: that labor rates and labor costs are the same thing. But how different they really are. The second set of minimills paid its workers at a rate Of \$3.45 an hour more than the first. But according to data collected by Fairfield University Professor Jeffrey Arthur, its labor costs were much lower because the productivity of the mills was higher. The second set of mills actually required 34% fewer labor hours to produce a ton of steel than the first set and also generated 63% less scrap. The second set of mills could have raised workers' pay rate by 19% and still had lower labor costs.

Connected to the first myth are three more myths that draw on the same logic. When managers believe that labor costs and labor rates are the same thing, they also tend to believe that they can cut labor costs by cutting labor rates. That's Myth #2. Again, this leaves out the important matter of productivity. I may replace my \$2,000-a-week engineers with ones that earn \$500 a week, but my costs may skyrocket because the new, lower-paid employees are inexperienced, slow, and less capable. In that case, I would have increased my costs by cutting my rates.

Managers who mix up labor rates and labor costs also tend to accept Myth #3: that labor costs are a significant portion of total costs. Sometimes, that's true. It is, for example, at accounting and consulting firms. But the ratio of labor costs to total costs varies widely in different industries and companies. And even where it is true, it's not as important as many managers believe. Those who swallow Myth #4 -- that low labor costs are a potent competitive strategy -- may neglect other, more effective ways of competing, such as through quality, service, delivery, and innovation. In reality, low labor costs are a slippery way to compete and perhaps the least sustainable competitive advantage there is.

Those of you who believed that the airline trying to compete in the low-cost, low-frills segment of the U.S. market would not succeed without using individual incentives succumbed to Myth #5: that the most effective way to motivate people to work productively is through individual incentive compensation. But Southwest Airlines has never used such a system, and it is the cost and productivity leader in its industry. Southwest is not alone, but still it takes smart, informed managers to buck the trend of offering individual rewards.

Would you have invested in the computer software company that didn't offer its people bonuses, stock options, or other financial incentives that could make them millionaires? You should have because it has succeeded mightily, growing over the past 21 years at a compound annual rate of more than 25%. The company is the SAS Institute of Cary, North Carolina. Today it is the largest privately held company in the software industry, with 1997 revenues of some \$750 million.

Rather than emphasize pay, SAS has achieved an unbelievably low turnover rate below 4% -- in an industry where the norm is closer to 20% -- by offering intellectually engaging work; a family-friendly environment that features exceptional benefits; and the opportunity to work with fun, interesting people using state-of-the-art equipment.

In short, SAS has escaped Myth #6: that people work primarily for money. SAS, operating under the opposite assumption, demonstrates otherwise. In the last three years, the company has lost none of its 20 North American district sales managers. How many software companies do you know could make that statement, even about the last three months?

Every day, I see managers harming their organizations by believing in these myths about pay. What I want to do in these following pages is explore some factors that help account for why the myths are so pervasive, present some evidence to disprove their underlying assumptions, and suggest how leaders might think more productively and usefully about the important issue of pay practices in their organizations.

### Why the Myths Exist

On October 10, 1997, the Wall Street Journal published an article expressing surprise that a "contrarian Motorola" had chosen to build a plant in Germany to make cellular phones despite the notoriously high "cost" of German labor. The Journal is not alone in framing business decisions about pay in this way. The Economist has also written articles about high German labor "costs," citing as evidence labor rates (including fringe benefits) of more than \$30 per hour.

The semantic confusion of labor rates with labor costs, endemic in business journalism and everyday discussion, leads managers to see the two as equivalent. And when the two seem equivalent, the associated myths about labor costs seem

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to make sense, too. But, of course, labor rates and labor costs simply aren't the same thing. A labor rate is total salary divided by time worked. But labor costs take productivity into account. That's how the second set of minimills managed to have lower labor costs than the mills with the lower wages. They made more steel, and they made it faster and better.

Another reason why the confusion over costs and rates persists is that labor rates are a convenient target for managers who want to make an impact. Labor rates are highly visible, and it's easy to compare the rates you pay with those paid by your competitors or with those paid in other parts of the world. In addition, labor rates often appear to be a company's most malleable financial variable. It seems a lot quicker and easier to cut wages than to control costs in other ways, like reconfiguring manufacturing processes, changing corporate culture, or altering product design. Because labor costs appear to be the lever closest at hand, managers mistakenly assume it is the one that has the most leverage.

For the myths that individual incentive pay drives creativity and productivity, and that people are primarily motivated by money, we have economic theory to blame. More specifically, we can blame the economic model of human behavior widely taught in business schools and held to be true in the popular press. This model presumes that behavior is rational -- driven by the best information available at the time and designed to maximize the individual's self-interest. According to this model, people take jobs and decide how much effort to expend in those jobs based on their expected financial return. If pay is not contingent on performance, the theory goes, individuals will not devote sufficient attention and energy to their jobs.

Additional problems arise from such popular economic concepts as agency theory (which contends that there are differences in preference and perspective between owners and those who work for them) and transaction-cost economics (which tries to identify which transactions are best organized by markets and which by hierarchies). Embedded in both concepts is the idea that individuals not only pursue self-interest but do so on occasion with guile and opportunism. Thus agency theory suggests that employees have different objectives than their employers and, moreover, have opportunities to misrepresent information and divert resources to their personal use. Transaction-cost theory suggests that people will make false or empty threats and promises to get better deals from one another.

All of these economic models portray work as hard and aversive -- implying that the only way people can be induced to work is through some combination of rewards and sanctions. As professor James N. Baron of Stanford Business School has written, "The image of workers in these models is somewhat akin to Newton's first law of motion: employees remain in a state of rest unless compelled to change that state by a stronger force impressed upon them -- namely, an optimal labor contract."

Similarly, the language of economics is filled with terms such as shirking and free riding. Language is powerful, and as Robert Frank, himself an economist, has noted, theories of human behavior become self-fulfilling. We act on the basis of these theories, and through our own actions produce in others the behavior we expect. If we believe people will work hard only if specifically rewarded for doing so, we will provide contingent rewards and thereby condition people to work only when they are rewarded. If we expect people to be untrustworthy, we will closely monitor and control them and by doing so will signal that they can't be trusted -- an expectation that they will most likely confirm for us.

So self-reinforcing are these ideas that you almost have to avoid mainstream business to get away from them. Perhaps that's why several companies known to be strongly committed to managing through trust, mutual respect, and true decentralization -- such as AES Corporation, Lincoln Electric, the Men's Wearhouse, the SAS Institute, ServiceMaster, Southwest Airlines, and Whole Foods Market -- tend to avoid recruiting at conventional business schools.

There's one last factor that helps perpetuate all these myths: the compensation-consulting industry. Unfortunately, that industry has a number of perverse incentives to keep these myths alive.

First, although some of these consulting firms have recently broadened their practices, compensation remains their bread and butter. Suggesting that an organization's performance can be improved in some way other than by tinkering with the pay system may be empirically correct but is probably too selfless a behavior to expect from these firms.

Second, if it's simpler for managers to tinker with the compensation system than to change an organization's culture, the way work is organized, and the level of trust and respect the system displays, it's even easier for consultants. Thus both the compensation consultants and their clients are tempted by the apparent speed and ease with which reward-system

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solutions can be implemented.

Third, to the extent that changes in pay systems bring their own new predicaments, the consultants will continue to have work solving the problems that the tinkering has caused in the first place.

### From Myth to Reality: A Look at the Evidence

The media are filled with accounts of companies attempting to reduce their labor costs by laying off people, moving production to places where labor rates are lower, freezing wages, or some combination of the above. In the early 1990s, for instance, Ford decided not to award merit raises to its white-collar workers as part of a new cost-cutting program. And in 1997, General Motors endured a series of highly publicized strikes over the issue of outsourcing. GM wanted to move more of its work to nonunion, presumably lower-wage, suppliers to reduce its labor costs and become more-profitable.

Ford's and GM's decisions were driven by the myths that labor rates and labor costs are the same thing, and that labor costs constitute a significant portion of total costs. Yet hard evidence to support those contentions is slim. New United Motor Manufacturing, the joint venture between Toyota and General Motors based in Fremont, California, paid the highest wage in the automobile industry when it began operations in the mid-1980s, and it also offered a guarantee of secure employment. With productivity some 50% higher than at comparable GM. plants, the venture could afford to pay 10% more and still come out ahead.

Yet General Motors apparently did not learn the lesson that what matters is not pay rate but productivity. In May 1996, as GM was preparing to confront the union over the issue of outsourcing, the "Harbour Report," the automobile industry's bible of comparative efficiency, published some interesting data suggesting that General Motors' problems had little to do with labor rates. As reported in the Wall Street Journal at the time, the report showed that it took General Motors some 46 hours to assemble a car, while it took Ford just 37.92 hours, Toyota 29.44, and Nissan only 27.36. As a way of attacking cost problems, officials at General Motors should have asked why they needed 21% more hours than Ford to accomplish the same thing or why GM was some 68% less efficient than Nissan.

For more evidence of how reality really looks, consider the machine tool industry. Many of its senior managers have been particularly concerned with low-cost foreign competition, believing that the cost advantage has come from the lower labor rates available offshore. But for machine tool companies that stop fixating on labor rates and focus instead on their overall management system and manufacturing processes, there are great potential returns. Cincinnati Milacron, a company that had virtually surrendered the market for low-end machine tools to Asian competitors by the mid-1980s, overhauled its assembly process, abolished its stockroom, and reduced job categories from seven to one. Without any capital investment, those changes in the production process reduced labor hours by 50%, and the company's productivity is now higher than its competitors' in Taiwan.

Even U.S. apparel manufacturers lend support to the argument that labor costs are not the be-all and end-all of profitability. Companies in this industry are generally obsessed with finding places where hourly wages are low. But the cost of direct labor needed to manufacture a pair of jeans is actually only about 15% of total costs, and even the direct labor involved in producing a man's suit is only about \$12-50.<sup>(1)</sup>

Compelling evidence also exists to dispute the myth that competing on labor costs will create any sustainable advantage. Let's start close to home. One day, I arrived at a large discount store with a shopping list. Having the good fortune to actually find a sales associate, I asked him where I could locate the first item on my list. "I don't know," he replied. He gave a similar reply when queried about the second item. A glance at the long list I was holding brought the confession that because of high employee turnover, the young man had been in the store only a few hours himself. What is that employee worth to the store? Not only can't he sell the merchandise, he can't even find it! Needless to say, I wasn't able to purchase everything on my list because I got tired of looking and gave up. And I haven't returned since. Companies that compete on cost alone eventually bump into consumers like me. It's no accident that Wal-Mart combines its low-price strategy with friendly staff members greeting people at the door and works assiduously to keep turnover low.

Another example of a company that understands the limits of competing solely on labor costs is the Men's Wearhouse, the enormously successful off-price retailer of tailored men's clothing. The company operates in a fiercely competitive industry in which growth is possible primarily by taking sales from competitors, and price wars are intense. Still, less than

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15% of the company's staff is part-time, wages are higher than the industry average, and the company engages in extensive training. All these policies defy conventional wisdom for the retailing industry. But the issue isn't what the Men's Warehouse's employees cost, it's what they can do: sell very effectively because of their product knowledge and sales skills. Moreover, by keeping inventory losses and employee turnover low, the company saves money on shrinkage and hiring. Companies that miss this point -- that costs, particularly labor costs, aren't everything -- often overlook ways of succeeding that competitors can't readily copy.

Evidence also exists that challenges the myth about the effectiveness of individual incentives. This evidence, however, has done little to stem the tide of individual merit pay. A survey of the pay practices of the Fortune 1,000 reported that between 1987 and 1993, the proportion of companies using individual incentives for at least 20% of their workforce increased from 38% to 50% while the proportion of companies using profit sharing -- a more collective reward -- decreased from 45% to 43%. Between 1981 and 1990, the proportion of retail salespeople that were paid solely on straight salary, with no commission, declined from 21% to 7%. And this trend toward individual incentive compensation is not confined to the United States. A study of pay practices at plants in the United Kingdom reported that the proportion using some form of merit pay had increased every year since 1986 such that by 1990 it had reached 50%.<sup>(2)</sup>

Despite the evident popularity of this practice, the problems with individual merit pay are numerous and well documented. It has been shown to undermine teamwork, encourage employees to focus on the short term, and lead people to link compensation to political skills and ingratiating personalities rather than to performance. Indeed, those are among the reasons why W. Edwards Deming and other quality experts have argued strongly against using such schemes.

Consider the results of several studies. One carefully designed study of a performance-contingent pay plan at 20 Social Security Administration offices found that merit pay had no effect on office performance. Even though the merit pay plan was contingent on a number of objective indicators, such as the time taken to settle claims and the accuracy of claims processing, employees exhibited no difference in performance after the merit pay plan was introduced as part of a reform of civil service pay practices. Contrast that study with another that examined the elimination of a piecework system and its replacement by a more group-oriented compensation system at a manufacturer of exhaust system components. There, grievances decreased, product quality increased almost tenfold, and perceptions of teamwork and concern for performance all improved.<sup>(3)</sup>

Surveys conducted by various consulting companies that specialize in management and compensation also reveal the problems and dissatisfaction with individual merit pay. For instance, a study by the consulting firm William M. Mercer reported that 73% of the responding companies had made major changes to their performance-management plans in the preceding two years, as they experimented with different ways to tie pay to individual performance. But 47% reported that their employees found the systems neither fair nor sensible, and 51% of the employees said that the performance-management system provided little value to the company. No wonder Mercer concluded that most individual merit or performance-based pay plans share two attributes: they absorb vast amounts of management time and resources, and they make everybody unhappy.

One concern about paying on a more group-oriented basis is the so-called free-rider problem, the worry that people will not work hard because they know that if rewards are based on collective performance and their colleagues make the effort, they will share in those rewards regardless of the level of their individual efforts. But there are two reasons why organizations should not be reluctant to design such collective pay systems.

First, much to the surprise of people who have spent too much time reading economics, empirical evidence from numerous studies indicates that the extent of free riding is quite modest. For instance, one comprehensive review reported that "under the conditions described by the theory as leading to free riding, people often cooperate instead."<sup>(4)</sup>

Second, individuals do not make decisions about how much effort to expend in a social vacuum; they are influenced by peer pressure and the social relations they have with their workmates. This social influence is potent, and although it may be somewhat stronger in smaller groups, it can be a force mitigating against free riding even in large organizations. As one might expect, then, there is evidence that organizations paying on a more collective basis, such as through profit sharing or gain sharing, outperform those that don't.

Sometimes, individual pay schemes go so far as to affect customers. Sears was forced to eliminate a commission system

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at its automobile repair stores in California when officials found widespread evidence of consumer fraud. Employees, anxious to meet quotas and earn commissions on repair sales, were selling unneeded services to unsuspecting customers. Similarly, in 1992, the Wall Street Journal reported that Highland Superstores, an electronics and appliance retailer, eliminated commissions because they had encouraged such aggressive behavior on the part of salespeople that customers were alienated.

Enchantment with individual merit pay reflects not only the belief that people won't work effectively if they are not rewarded for their individual efforts but also the related view that the road to solving organizational problems is largely paved with adjustments to pay and measurement practices. Consider again the data from the Mercer survey: nearly three-quarters of all the companies surveyed had made major changes to their pay plans in just the past two years. That's tinkering on a grand scale. Or take the case of Air Products and Chemicals of Allentown, Pennsylvania. When on October 23, 1996, the company reported mediocre sales and profits, the stock price declined from the low \$60s to the high \$50s. Eight days later, the company announced a new set of management-compensation and stock-ownership initiatives designed to reassure Wall Street that management cared about its shareholders and was demonstrating that concern by changing compensation arrangements. The results were dramatic. On the day of the announcement, the stock price went up 1 1/4, points, and the next day it rose an additional 4 4/3 points. By November 29, Air Products' stock had gone up more than 15%. According to Value Line, this rise was an enthusiastic reaction by investors to the new compensation system. No wonder managers are so tempted to tamper with pay practices!

But as Bill Strusz, director of corporate industrial relations at Xerox in Rochester, New York, has said, if managers seeking to improve performance or solve organizational problems use compensation as the only lever, they will get two results: nothing will happen, and they will spend a lot of money. That's because people want more out of their jobs than just money. Numerous surveys—even of second-year M.B.A. students, who frequently graduate with large amounts of debt—indicate that money is far from the most important factor in choosing a job or remaining in one.

Why has the SAS Institute had such low turnover in the software industry despite its tight labor market? When asked this question, employees said they were motivated by SAS's unique perks—plentiful opportunities to work with the latest and most up-to-date equipment and the ease with which they could move back and forth between being a manager and being an individual contributor. They also cited how much variety at here was in the projects they worked on, how intelligent and nice the people they worked with were, and how much the organization cared for and appreciated them. Of course, SAS pays competitive salaries, but in an industry in which people have the opportunity to become millionaires through stock options by moving to a competitor, the key to retention is SAS's culture, not its monetary rewards.

People seek, in a phrase, an enjoyable work environment. That's what AES, the Men's Wearhouse, SAS, and Southwest have in common. One of the core values at each company is fun. When a colleague and I wrote a business school case on Southwest, we asked some of the employees, a number of whom had been offered much more money to work elsewhere, why they stayed. The answer we heard repeatedly was that they knew what the other environments were like, and they would rather be at a place, as one employee put it, where work is not a four-letter word. This doesn't mean work has to be easy. As an AES employee noted, fun means working in a place where people can use their gifts and skills and can work with others in an atmosphere of mutual respect.

There is a great body of literature on the effect of large external rewards on individuals' intrinsic motivation. The literature argues that extrinsic rewards diminish intrinsic motivation and, moreover, that large extrinsic rewards can actually decrease performance in tasks that require creativity and innovation. I would not necessarily go so far as to say that external rewards backfire, but they certainly create their own problems. First, people receiving such rewards can reduce their own motivation through a trick of self-perception, figuring, "I must not like the job if I have to be paid so much to do it" or "I make so much, I must be doing it for the money." Second, they undermine their own loyalty or performance by reacting against a sense of being controlled, thinking something like, "I will show the company that I can't be controlled just through money."

But most important, to my mind, is the logic in the idea that any organization believing it can solve its attraction, retention, and motivation problems solely by its compensation system is probably not spending as much time and effort as it should on the work environment—on defining its jobs, on creating its culture, and on making work fun and meaningful. It is a question of time and attention, of scarce managerial resources. The time and attention spent managing the reward system are not available to devote to other aspects of the work environment that in the end may be much more critical to success.

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### Some Advice About Pay

Since I have traipsed you through a discussion of what's wrong with the way most companies approach compensation, let me now offer some advice about how to get it right.

The first, and perhaps most obvious, suggestion is that managers would do well to keep the difference between labor rates and labor costs straight. In doing so, remember that only labor costs--and not labor rates--are the basis for competition, and that labor costs may not be a major component of total costs. In any event, managers should remember that the issue is not just what you pay people, but also what they produce.

To combat the myth about the effectiveness of individual performance pay, managers should see what happens when they include a large dose of collective rewards in their employees' compensation package. The more aggregated the unit used to measure performance, the more reliably performance can be assessed. One can tell pretty accurately how well an organization, or even a subunit, has done with respect to sales, profits, quality, productivity, and the like. Trying to parcel out who, specifically, was responsible for exactly how much of that productivity, quality, or sales is frequently much more difficult or even impossible. As Herbert Simon, the Nobel-prize-winning economist, has recognized, people in organizations are interdependent, and therefore organizational results are the consequence of collective behavior and performance. If you could reliably and easily measure and reward individual contributions, you probably would not need an organization at all as everyone would enter markets solely as individuals.

In the typical individual-based merit pay system, the boss works with a raise budget that's some percentage of the total salary budget for the unit. It's inherently a zero-sum process: the more I get in my raise, the less is left for my colleagues. So the worse my workmates perform, the happier I am because I know I will look better by comparison. A similar dynamic can occur across organizational units in which competition for a fixed bonus pool discourages people from sharing best practices and learning from employees in other parts of the organization. In November 1995, for example, Fortune magazine reported that at Lantech, a manufacturer of packaging machinery in Louisville, Kentucky, individual incentives caused such intense rivalry that the chairman of the company, Pat Lancaster, said, "I was spending 95% of my time on conflict resolution instead of on how to serve our customers."

Managers can fight the myth that people are primarily motivated by money by de-emphasizing pay and not portraying it as the main thing you get from working at a particular company. How? Consider the example of Tandem Computer which, in the years before it was acquired by Compaq, would not even tell you your salary before expecting you to accept a job. If you asked, you would be told that Tandem paid good, competitive salaries. The company had a simple philosophy--if you came for money, you would leave for money, and Tandem wanted employees who were there because they liked the work, the culture, and the people, not something--money--that every company could offer. Emphasizing pay as the primary reward encourages people to come and to stay for the wrong reasons. AES, a global independent power producer in Arlington, Virginia, has a relatively short vesting period for retirement-plan contributions and tries not to pay the highest salaries for jobs in its local labor market. By so doing, it seeks to ensure that people are not locked into working at a place where they don't want to be simply for the money.

Managers must also recognize that pay has substantive and symbolic components. In signaling what and who in the organization is valued, pay both reflects and helps determine the organization's culture. Therefore, managers must make sure that the messages sent by pay practices are intended. Talking about teamwork and cooperation and then not having a group-based component to the pay system matters because paying solely on an individual basis signals what the organization believes is actually important--individual behavior and performance. Talking about the importance of all people in the organization and then paying some disproportionately more than others belies that message. One need not go to the extreme of Whole Foods Market, which pays no one more than eight times the average company salary (the result being close to \$1 billion in sales at a company where the CEO makes less than \$200,000 a year). But paying large executive bonuses while laying off people and asking for wage freezes, as General Motors did in the 1980s, may not send the right--message, either. When Southwest Airlines asked its pilots for a five-year wage freeze, CEO Herb Kelleher voluntarily asked the compensation committee to freeze his salary for at least four years as well. The message of shared, common fate is powerful in an organization truly seeking to build a culture of teamwork.

Making pay practices public also sends a powerful symbolic message. Some organizations reveal pay distributions by position or level. A few organizations, such as Whole Foods Market, actually make data on individual pay available to all

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members who are interested. Other organizations try to maintain a high level of secrecy about pay. What message do those organizations send? Keeping salaries secret suggests that the organization has something to hide or that it doesn't trust its people with the information. Moreover, keeping things secret just encourages people to uncover the secrets--if something is worth hiding, it must be important and interesting enough to expend effort discovering. Pay systems that are more open and transparent send a positive message about the equity of the system and the trust that the company places in its people.

Managers should also consider using other methods besides pay to signal company values and focus behavior. The head of North American sales and operations for the SAS Institute has a useful perspective on this issue. He didn't think he was smart enough to design an incentive system that couldn't be gamed. Instead of using the pay system to signal what was important, he and other SAS managers simply told people what was important for the company and why. That resulted in much more nuanced and rapid changes in behavior because the company didn't have to change the compensation system every time business priorities altered a little. What a novel idea--actually talking to people about what is important and why, rather than trying to send some subtle signals through the compensation system!

Perhaps most important, leaders must come to see pay for what it is: just one element in a set of management practices that can either build or reduce commitment, teamwork, and performance. Thus my final piece of advice about pay is to make sure that pay practices are congruent with other management practices and reinforce rather than oppose their effects.

### Breaking with Convention To Break the Myths

Many organizations devote enormous amounts of time and energy to their pay systems, but people, from senior managers to hourly workers, remain unhappy with them. Organizations are trapped in unproductive ways of approaching pay, which they find difficult to escape. The reason, I would suggest, is that people are afraid to challenge the myths about compensation. It's easier and less controversial to see what everyone else is doing and then to do the same. In fact, when I talk to executives at companies about installing pay systems that actually work, I usually hear, "But that's different from what most other companies are saying and doing."

It must certainly be the case that a company cannot earn "abnormal" returns by following the crowd. That's true about marketplace strategies, and it's true about compensation. Companies that are truly exceptional are not trapped by convention but instead see and pursue a better business model.

Companies that have successfully transcended the myths about pay know that pay cannot substitute for a working environment high on trust, fun, and meaningful work. They also know that it is more important to worry about what people do than what they cost, and that zero-sum pay plans can set off internal competition that makes learning from others, teamwork, and cross-functional cooperation a dream rather than the way the place works on an everyday basis.

There is an interesting paradox in achieving high organizational performance through innovative pay practices--if it were easy to do, it wouldn't provide as much competitive leverage as it actually does. So while I can review the logic and evidence and offer some alternative ways of thinking about pay, it is the job of leaders to exercise both the judgment and the courage necessary to break with common practice. Those who do will develop organizations in which pay practices actually contribute rather than detract from building high-performance management systems. Those who are stuck in the past are probably doomed to endless tinkering with pay; at the end of the day, they won't have accomplished much, but they will have expended a lot of time and money doing it.

Related Article: TRUTH AND CONSEQUENCES: THE SIX DANGEROUS MYTHS ABOUT COMPENSATION

#### Myth

1. Labor rates and labor costs are the same thing.

#### Reality

1. They are not, and confusing them leads to a host of managerial missteps. For the record, labor rates are straight wages divided by time -- a Wal-Mart cashier earns

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\$5.15 an hour, a Wall Street attorney \$2,000 a day. Labor costs are a calculation of how much a company pays its people and how much they produce. Thus German factory workers may be paid at a rate of \$30 an hour and Indonesians \$3, but the workers' relative costs will reflect how many widgets are produced in the same period of time.

2. You can lower your labor costs by cutting labor rate.

2. When managers buy into the myth that labor rates and labor costs are the same thing, they usually fall for this myth as well. Once again, then, labor costs are a function of labor rates and productivity. To lower labor costs, you need to address both. Indeed, sometimes lowering labor rates increases labor costs.

3. Labor costs constitute a significant proportion of total costs.

3. This is true -- but only sometimes. Labor costs as a proportion of total costs vary widely by industry and company. Yet many executives assume labor costs are the biggest expense on their income statement. In fact, labor costs are only the most immediately malleable expense.

4. Low labor costs are a potent and sustainable competitive weapon

4. In fact, labor costs are perhaps the most slippery and least sustainable way to compete. Better to achieve competitive advantage through quality; through customer service; through product, process, or service innovation; or through technology leadership. It is much more difficult to imitate these sources of competitive advantage than to merely cut costs.

5. Individual incentive pay improves performance

5. Individual incentive pay, in reality, undermines performance -- of both the individual and the organization. Many studies strongly suggest that this form of reward undermines teamwork, encourages a short-term focus, and leads people to believe

## Six dangerous myths about pay.

that pay is not related to performance at all but to having the "right" relationships and an ingratiating personality.

6. People work for money.

6. People do work for money -- but they work even more for meaning in their lives. In fact, they work to have fun. Companies that ignore this fact are essentially bribing their employees and will pay the price in a lack of loyalty and commitment.

(1.) John T. Dunlop and David Weil, "Diffusion and Performance of Modular Production in the U.S. Apparel Industry," *Industrial Relations*, July 1996, p. 337.

(2.) For the survey of the pay practices of Fortune 1,000 companies, see Gerald E. Ledford, Jr., Edward E. Lawler III, and Susan A. Mohrman, "Reward Innovations in Fortune 1,000 Companies," *Compensation and Benefits Review*, April 1995, p. 76, for the salary and commission data, see Gregory A. Patterson, "Distressed Shoppers, Disaffected Workers Prompt Stores to Alter Sales Commissions," *the Wall Street Journal*, July 1, 1992, p. B1; for the study of U.K. pay practices, see Stephen Wood, "High Commitment Management and Payment Systems," *Journal of Management Studies*, January 1996, p. 53.

(3.) For the Social Security Administration study, see Jone L. Pearce, William B. Stevenson, and James L. Perry, "Managerial Compensation Based on Organizational Performance: A Time Series Analysis of the Effects of Merit Pay," *Academy of Management Journal*, June 1985, p. 261; for the study of group-oriented compensation, see Larry Hatcher and Timothy L. Ross, "From Individual Incentives to an Organization-Wide Gainsharing Plan: Effects on Teamwork and Product Quality," *Journal of Organizational Behavior*, May 1991, p. 169.

(4.) Gerald Marwell, "Altruism and the Problem of Collective Action," in V.J. Derlega and J. Grzelak, eds., *Cooperation and Helping Behavior: Theories and Research* (New York: Academic Press, 1982), p. 298.

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