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# 3

## Labour economics, competition and compensation

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### INTRODUCTION

The aim of this chapter is to review the contribution of economics to the understanding of the remuneration of labour. In much of their work, economists are primarily talking to other economists in a common, technical language which makes it less than easy for non-economists to carry the findings of economics across to their own areas of interest. A key task of the present chapter is to convey an understanding of the economic analysis of remuneration in such a way that it will be helpful to personnel practitioners in resolving the many challenges posed for them by the design and consequences of different approaches to employee compensation.

We begin with a statement of the standard core of the economic theory of pay, based on the neoclassical paradigm which has been much criticised but remains the starting point for most economists. We consider the main lines of criticism and defence: the debate has led to some important amendments and extensions of the theoretical core, but has not replaced it with a new superior theory. Earlier criticisms from institutional economists were perhaps relatively easily shaken off by the defenders of the orthodox theory, but the critique has persisted and more important theoretical objections have been developed and supported by powerful empirical evidence. We go on to discuss four of the most significant developments, relating to efficiency wages, bargaining models, internal labour markets and agency theory which are particularly relevant to the aims of this chapter. In conclusion we focus on two important areas of current concern, executive compensation and profit-sharing schemes, which arguably provide some insights into economic approaches which are capable of making more positive contributions to the problems faced by the practitioner.

Our aim in this chapter is not to try to resolve the differences among the various approaches, but rather to point to ways in which economic analysis may be helpful to practitioners in addressing their own problems. The more a firm or a business sector approaches the conditions of full and effective competition, the more likely it is that the competitive theory will provide useful pointers. But where competition, whether in the product market or in the labour market, is restricted, the greater the departure

from competitive theory that is required to explain empirical observations or to analyse the consequences of alternative strategies for remuneration.

### THE 'STANDARD' COMPETITIVE APPROACH

For the economist, wage rates are the price of labour services which act as signals to allocate labour resources efficiently among competing alternative employments. As soon as we acknowledge differences in the skills and other attributes of labour we are faced with the need to explain, not just a wage *level* and its movements but also a wages *structure*. Conventional market principles suggest that wages will be determined by the interaction of demand and supply. The demand for labour is derived from the demand for the goods and services that labour will produce, while the supply of labour depends on the willingness of individuals to provide labour to the market at different offer levels of (real) wages. In other words, wages are a form of compensation that will draw labour into the market and persuade individuals to give up leisure which they value positively. If the wage is too low, the potential worker will not achieve his or her reservation wage (the wage required to compensate for the loss of leisure) and no labour will be forthcoming. If the wage is too high, more workers will be attracted into the market than are required by employers and there will be unemployment. In a freely operating market, price changes act as a signal of shortage and surplus by floating up or down to correct imbalances and restore equilibrium.

This standard market approach is encapsulated in neoclassical wage theory in which the demand for labour is dependent on the marginal productivity of the employee (or the unit of labour resource): profit-maximizing employers will hire labour up to the point at which the value of the increment of output to the employer is just equal to the addition to labour costs. With the assumption of homogeneous labour such that one unit of labour is readily substituted for another, and with perfect information flowing freely in the market place, full employment should be a natural condition to which the economic system will tend due to competition among employers (for workers) and competition among workers (for jobs). Under competitive conditions, the law of one price will hold: that is, wages for equivalent workers will not vary among employers. Differences in wages will reflect only short-term friction in the matching process of the market, differences in the risk or unpleasantness attaching to different kinds of work or perhaps the differing tastes of individuals for different kinds of work – reflecting vocational preferences. Subject to these conditions, wages will gravitate to a level at which the net advantages (both pecuniary and non-pecuniary) of different employments are equalised: persistent differences over time are viewed as *compensating differentials*.

The problem is that the real labour market does not fulfil these conditions. The empirical evidence reveals long-term departures from full employment, a tendency for wages to be relatively inflexible downwards, and differentials in pay which are difficult to explain in terms of the standard competitive theory. Economists have responded to this problem in various ways. Strict neoclassical theorists have introduced a number of amendments to get round the difficulties, while others have sought alternative theories. Virtually all these approaches are characterised by the pursuit of an *economically rational explanation* for the apparent discrepancies. Richard Thaler (1989: 181) observes:

Economics can be distinguished from other social sciences by the belief that most (all?) behavior can be explained by assuming that agents have stable, well-defined preferences and make rational choices consistent with those preferences in markets that (eventually) clear.

Within this framework, wages serve to allocate labour across job vacancies and the outcome in terms of the wage structure and the distribution of income is typically assessed in efficiency terms. This is quite different in purpose from the social interpretation of wages as providing a legitimate basis for social stratification and social cohesion, and different again from the management approach to remuneration as a tool capable of motivating and raising the performance of workers. Economics has its own agenda.

But this rationalist economic approach is now coming under question as a result of recent trends in the labour market, particularly the observation of growing inequality in pay and economic opportunity, and in the implications of enhanced 'flexibility' deriving from the deregulation of the labour market. As Rubery (1997: 338) puts it:

The predominant theories, from the neo-classical to the radical, have overstressed coherence and functionality and underplayed both the persistence of conflict and contradictions and the scope for discretionary, random or opportunistic decisions . . . wage determination decisions have been held partially in check in the past by a series of institutional and social processes which served to link wage determination across sectors and organizations and labour force groups. Many of these processes . . . have disintegrated in the 1980s and 1990s.

If this is a valid critique, it implies that a fully satisfactory theory of the behaviour of wages needs to break out of the straitjacket of rationality and accept that much of the 'noise' in the system, which continues to cause problems for the social scientist, is due to forms of behaviour which are not consistently rational and orderly. If, at the same time, some institutional and social forces operating on the wage mechanism are weakening, the scale of the 'noise' problem may be increasing and the search for a new approach may be more pressing. In the meantime we will focus on the attempts of the economist to bring the theory based on rational principles of allocative efficiency into line with increasingly rich empirical evidence on wage behaviour and structures and seek to assess its value for the manager.

### CRITICS, DEFENCE AND DEVELOPMENT

The neoclassical theory based on the marginal productivity theory of demand has long had its critics. For example, Lester (1946) argued that the theory was unrealistic as employers cannot and do not think in terms of marginal revenue calculations. The orthodox response was that this was not necessary, as long as the economic agents behaved *as if* they were profit maximising. If theory based on specific assumptions provided good predictions, it was doing its job even if the assumptions proved to be poor descriptors of reality. The defenders of the orthodox theory (e.g. Rees, 1973: 58) also pointed to the fact that the critics had failed to come up with a convincing alternative and there was no justification for discarding the conventional approach – though a number of developments were introduced in order to cope more satisfactorily with the awkward facts thrown up by new empirical research. A pragmatic defence acceptable to many might run as follows (Reynolds, Masters and Moser, 1986: 135):

Although the economic environment of firms is more uncertain and more complex than the simple marginal productivity theory suggests, the theory is still highly useful. Firms may not be able to maximize profits with a precision in determining their optimal employment levels. The attention of a firm's top executives is a scarce resource, so small differences in wage rates do not always influence important decisions. Nevertheless, large differences in wage rates cannot be ignored without jeopardizing the firm's survival. In this sense, the survival principle appears valid, even in a complex, uncertain and changing economy. Therefore, the conclusions of the marginal productivity theory have wide applicability, even if the reasoning that leads to them may appear oversimplified. Of particular importance, the demand for labour does have a negative slope.

Criticisms of competitive labour market theory continued to grow, particularly in the United States, with the lead in this regard being taken by the 'institutional' labour economists of the 1940s and 1950s. It was contended that competitive theory was useful only for three basic purposes (Pierson, 1957: 18–19):

- 1 providing a theoretical benchmark for studying the operation of labour markets;
- 2 as a guide to predicting very general or long-run tendencies in wage relationships;
- 3 as a reminder that competitive forces place distinct limits or bounds on the administrative discretion of managers, union leaders and government officials.

This judgement was underpinned by a series of 'real-world' surveys and case studies which variously documented (i) the imperfect information and mobility of employees in searching for jobs; (ii) the existence of wage differentials that were inconsistent with the predictions of competitive theory; and (iii) the impact of institutional arrangements, such as collective bargaining, on wage levels. However, the institutionalists made only limited progress in developing an alternative framework of analysis, although some of their work was important in initiating the notion of *internal labour markets*.<sup>1</sup> From the 1960s their work experienced a strong 'counter attack' from advocates of competitive theory, based primarily at the University of Chicago. It is to this group which we now turn.

## RATIONAL BEHAVIOUR AND HUMAN CAPITAL

The institutional critics had argued that imperfections in the labour market were widespread, and that the assumptions of competitive theory did not reflect this reality. The advocates of competitive theory responded to this charge in two main ways. First (as noted earlier), they argued that the real test of a theory is not the realism of its assumptions, but rather its predictive value and power. Second, and more importantly, they sought to account for these imperfections in terms of rational behaviour. That is, they sought to *re-define* competitive theory by arguing that (Kaufman, 1994: 175–6):

alleged deviations from reality were themselves the product of rational, economizing behaviour by economic agents. The long-run effect of this argument has been to shift the entire focus of the debate from a test of the predictions of competitive theory *per se* to that of a theory of rational behaviour where rational behaviour means action consistent with maximization of self interest in response to a set of known (or estimated) benefits and costs.

In the extreme case this means that anything done by an economic agent is assumed to be rational and maximising – which may be all very well for explaining events *ex-post* but not very helpful in predicting behaviour.

A second development of much greater significance in the development of the neoclassical thinking also emerged in the 1960s, the introduction of a supply-side approach to the wage problem, embodied in *human capital theory*. Previously the supply of labour had been a necessary but rather neutral ingredient in the neoclassical theory, the main operative factor being demand acting through the marginal productivity principle. The new human capital approach emerged from the finding of T.W. Schultz that the prevalent economic models failed fully to account for US growth. The standard production theory of the day assumed that all units of capital and of labour were identical, but it was increasingly recognised that input quality, especially for labour, could have marked effects on productivity, affecting growth over time or across countries. Unmeasured human capital thus emerged as a factor able to contribute to the explanation of varying growth rates, and the study of investment in human capital began to open up a new vista for the understanding of wages.

Earnings were now seen as a reflection of the human capital embodied in individuals, who invest in education and training so as to maximise the discounted value of lifetime earnings. This investment raised productivity and hence the attractiveness of the worker to the employer who would pay higher wages to acquire it. The basic model is subject to a daunting set of simplifying assumptions. Over time, however, developments and extensions have emerged to provide a much more rounded theory capable of handling problems such as the differences between types of human capital investment, the effects of intermittent labour market participation and variations in attitudes to risk. Applications of the theory have shed light on the existence of the gender and ethnic minority wage gaps, job search behaviour and migration or mobility patterns. (For an excellent account of this development and extension of the basic theory see Polacheck and Siebert, 1993). Yet despite the undoubted strength of human capital theory in providing insights into much labour market and wage structure behaviour, some doubts remain. It is essentially a supply-side theory and it is not clear where the existing wage structure, on which investment decisions are supposed to be made, actually derives from. As Polacheck and Siebert (1993: 272) puts it:

how the human capital rental rate ( $w$ ) is determined is completely neglected in human capital literature.

Thus although human capital theory offers a unified explanation of much that we observe in the real world of wages and labour markets, there remain serious concerns that this is not the whole story.

## DEPARTURES FROM THE COMPETITIVE MODEL

Many contemporary labour economists still share the basic values and beliefs of the earlier institutional critics of competitive theory. They reject the basic view that labour markets operate along essentially similar lines to commodity markets. What is exchanged in the labour market is inherently embodied in people. As a consequence they argue that, first, one needs to develop a much broader and more complex theory

### Exhibit 3.1

#### Pay and the notion of fairness: two views

- 1 There is, of course, an established body of economic thought on the determination of rates of pay, which may be found in any contemporary textbook. But orthodox theory, though by no means so otiose as is sometimes suggested, is to my mind deficient in certain major respects. In particular, it fails to take account of the influence of ideas of fairness, especially in the minds of employees. The pattern of pay relativities is powerfully influenced also by normative forces. Of particular importance are pressures to eliminate or reduce various kinds of inequality of pay, pressures by certain comparatively highly paid groups to maintain their relative position, and pressures to ensure that pay relationships reflect authority relationships. Normative pressures of these and other sorts significantly modify the broad framework of relativities between different industries and occupational categories; they have a very large effect on relativities between particular establishments and between particular narrowly defined industries and occupations; and their influence is at its greatest as regards the various types of relativities within particular establishments and industries.
- 2 recent trends in personnel management . . . have been towards individualized and performance-related pay, delayering of hierarchies, and rapid increases in pay for high-fliers compared with bureaucratic deferred reward structures. Pay is legitimized by market value rather than by internal job descriptions, and redistribution towards higher earners has undermined notions of internal fairness.

Sources adapted from: (1) Wood (1978), pp. 1 and 203; and (2) Rubery (1997), p. 355.

of employee motivation in which social and psychological influences play an important role; in other words, a view of people as simple, rational, maximising agents is inadequate. Equity and fairness matter too. This has long been argued by some labour economists, such as Phelps Brown (1962: 4–6) in Britain, while Thaler (1989: 191) finds 'the pattern of industry wages difficult to understand unless we assume that firms pay attention to perceived equity in setting wages, an assumption that only an economist would find controversial'. Exhibit 3.1 contains a further reflection of this view, though a contemporary comment suggests that some of the traditional equity arguments are under challenge.

Second, this group attaches a great deal of importance to the notion of 'learning' which is seen as all-important in trying to ensure that organisational objectives are achieved via the 'people factor'. To them it is this wider, more complex nature of motivation, together with the notion of learning, that is so important in accounting for many of the observed patterns of behaviour and outcome that do not neatly square with the assumptions and predictions of competitive theory. They also attach a more important, and frequently 'positive', role to the influence of institutional arrangements in the labour market, as is illustrated by the findings of exhibit 3.2.

The link with the earlier institutional critics is underlined by Freeman (1989: 321):

one of the major conclusions which led the (older) generation of labor economists to reject the competitive model of the labor market was the finding of significant wage differences among workers doing seemingly similar work across industries and among plants within an industry in particular local labor markets. For a long time, modern labor economists ignored these results. . .

### Exhibit 3.2

#### Changes in the wage structure in four OECD countries

- 1 Educational and occupational wage differentials narrowed in the USA, Britain, Japan and France in the 1970s. But this pattern reversed itself with increases in skill differentials in the USA, Britain and Japan in the early 1980s, with a muted but somewhat similar pattern appearing in France from 1984.
- 2 Reductions in the rate of growth of the relative supply of college-educated workers in the face of persistent increases in the relative demand for more skilled labour can explain a substantial portion of the increase in educational wage differentials in the USA, Britain and Japan in the 1980s.
- 3 Similar changes in relative skill demands are likely to have occurred in France, but the effect of such changes on wages has been somewhat offset by a high minimum wage and the ability of French unions to extend contracts even in the face of declining membership.

Source: L. Katz, G. Loreman and D. Blanchflower, 1993.

More recently, younger economists interested in wage determination from a broader perspective have re-examined the role of the industry, establishment and firm in wage determination, with empirical findings totally supportive of the older generation . . . While all the modern analysts, like the older generation, have tried to build competitive studies to explain industry and plant differentials, the broad conclusion they have reached also mimics that of the older generation – namely, that competitive theory cannot explain the observed phenomenon.

The modern group of critics confronts the rational school of thought on grounds similar to the earlier institutional economists but employs essentially the same methodology as the neoclassical school (with an emphasis on deductive hypothesis testing using quantitative methods to analyse large bodies of survey data). Specifically, they analyse differentials that are inconsistent with the 'one price' rule for equivalent workers, predicted by competitive theory (reflecting individual productivity). Empirical evidence of sustained wage differentials linked to plant size, firm size and industry (even when measurable labour quality is held constant) is inconsistent with conventional theory. Exhibit 3.3 lists some specific findings from relevant micro-level British studies of this area.

As a consequence of these and similar findings, theories of wage determination departing further from the standard competitive version have developed. Groshen (1991) suggests five versions which progressively distance themselves from standard competitive theory in order to explain inter-firm wage differentials for similar workers: in simplified terms, these are:

- 1 workers not quite homogeneous due to innate or acquired worker quality, leading to firms sorting applicants by ability;
- 2 compensating differentials mitigate undesirable terms of employment deriving from management strategy or technological requirements;
- 3 random variations due to imperfect information, search costs and lags;
- 4 efficiency wages, where higher pay generates higher productivity;
- 5 bargaining, where the firm earns rent through its competitive advantage, but stakeholders are able to capture some part of it (or management is altruistic).

### Exhibit 3.3

#### Non-competitive wage model findings: some evidence from Britain

##### Study One

- Increases in a firm's market share, decreases in important penetration, and increases in the industry concentration ratio all serve to increase wages.

##### Study Two

- Firm-specific factors influence wages, but these effects are not influenced by union status, firm size or extent of market power.
- Conditions in the external labour market are a very important influence in company wages, although less so for firms with a high degree of market power.
- Product market power has a positive impact on wages, which is enhanced in large firms, but is not influenced by union status.

##### Study Three

- Employees who work in areas of high unemployment earn less, other things constant, than those who are surrounded by low unemployment; Bargaining and efficiency wage models are consistent with this pattern; This pattern is difficult to reconcile with the textbook competitive model of the labour market

Sources: Vainiomaki and Wadhvani (1991) (Study One); Nickell, Vainiomaki and Wadhvani (1992) (Study Two); Blanchflower and Oswald (1994), pp. 360–1 (Study Three).

The first two models are minor variants on the standard theory, while the third allows for random factors to intrude. The fourth and fifth models are more radical departures which require more discussion especially as they focus on management behaviour within the organisation and bear directly on our concerns here.

## CURRENT DEBATES

These moves away from standard competitive theory recognise that the level of firm-based compensation will vary considerably, reflecting the existence of discretion or choice available to firms. Once this is accepted a more open-ended approach becomes feasible. There is no problem in accepting that many firms have some monopoly power in their product market, enabling them to earn a 'rent' over and above the competitive level of profits. Once this rent is available the pressure of competition forcing firms to operate on the knife-edge of survival is reduced. Discretionary behaviour by managers, including decisions on pay for managers and workers alike, is possible. The limited effects of competition presumably allow firms paying above the market to survive since they are no longer on the knife-edge. But why should firms pay more for labour than would seem to be necessary?

### Efficiency wage theory

The basic belief here is that paying above the market rate will be efficient and profitable to the organisation, as it results in a positive impact on employee productivity. There are four leading versions of efficiency wage theory (Elliott, 1991: 349–51):

- 1 *The shirking model*: The contention here is that because individual worker productivity is often difficult to measure, this provides workers with the incentive to 'shirk'. However, if firms pay workers more than they can obtain elsewhere, they will be motivated to reduce shirking, because of the risk of being caught and hence losing this wage premium.
- 2 *The turnover model*: The contention here is that the wage premium is designed to reduce labour turnover which would involve considerable costs to the firm, particularly the loss of employees who have been in receipt of firm-specific training.
- 3 *The superior job applicant pool*: According to this version, it is not easy for firms to attract, identify and hire workers with high productivity potential. As a consequence, the high wage strategy is designed to attract a superior pool of applicants so that even random hiring produces a more productive workforce.
- 4 *Fair wages*: According to this version, the 'gift' of higher wages is reciprocated by a 'gift' of higher productivity. This is because these higher wages satisfy individual employee demands for equitable and fair treatment, and thus result in a reciprocal exchange of enhanced effort, reflected in increased morale and performance.

There are varying assessments of the worth and value of this particular body of work, largely due to the difficulties of developing suitable tests able to discriminate between different theories, but the following conclusion is one that might command broad support (Elliott, 1991: 352):

Recent attempts to explain these industry effects have focused on efficiency wage theory. This has the appeal that it attempts to explain why wage rates may be established and remain above the market clearing level. Some of the variants of efficiency wage theory are merely 'old wine in new bottles'. More novel are the versions that emphasize considerations of morale and fairness. These notions are by their very nature difficult to investigate empirically and it has to be admitted that at this time there is little empirical support for these versions of the theory. Such a remark is not meant to pour cold water on these ideas for they represent one of the more important developments in labour economics in recent years. However until we resolve some of the measurement difficulties standing in the way of empirical evaluation of these theories, our appreciation of the importance of these issues is likely to be severely curtailed.

### Bargaining models

Allowing again that firms are able to earn rent above normal profit due to some degree of monopoly power, it is possible for stakeholders in the firm to capture a share of that rent, either through bargaining or through altruism on the part of the employer. Trade unions, for example, may be able to engage in collective bargaining to increase the wage rates of their members by obtaining a mark-up on the market rate, thereby providing an incentive for employees to join the union. Equally, employers may feel disposed to share the benefits of their market position with managers (through executive perks) or employees on a discretionary basis – though this would be difficult to separate from the payment of efficiency wages. A special case arises in relation to senior executive compensation which we discuss below.

## Internal labour markets

A further development in labour economics with important implications for the analysis of pay at the firm or plant level has been the focus on *internal labour markets*. The internal labour market concept reflects the observed behaviour of many large organisations in which pay structure is effectively insulated from the forces of (external) labour market competition. Contact with the external labour market is confined to recruitment through limited 'ports of entry', and jobs in the organisation are arranged hierarchically. Employees receive company-specific training and are promoted in the hierarchy as they acquire skill and experience. Being sheltered from competitive forces, companies are not driven to relate wages directly to (marginal) productivity but can organise administrative systems of job allocation, training and career development, with an appropriate pay structure, to suit their own needs. Wages are attached to jobs rather than reflecting individual marginal productivity. The internal labour market thus breaks the link between competition and marginal productivity which is central to the competitive wage theory.

This challenge to conventional theory has been taken seriously, since the evidence indicates widespread use of internal labour market arrangements.<sup>2</sup> Again, however, the defendants of the neoclassical lines have sought to rationalise the challenge by arguing that 'the internal labour market is an efficiency-orientated institutional response to the basic market imperfections arising from specific training and the costs of information' (Addison and Siebert, 1979: 195): in other words, it is an organisational response to a form of market failure.

There is no doubt that internal labour markets have been – and remain – an important type of employment system adopted by employers to contribute to corporate objectives. They involve long-term employment relationships (employee commitment), substantial wage rigidity (reflecting income security and progression), an emphasis on internal promotion and training (human resource development) and a positive association between employee earnings and tenure (effective job matching) enhancing employee loyalty. Many personnel practitioners will recognise these features as design elements in their own organisations' remuneration policy, and their strong link into human resource management practice.

But it is worth noting that there has recently been some questioning about the future of the internal labour market. If the internal labour market was developed to overcome various forms of market failure, might it not be that, as the labour market itself undergoes change, this device will be less important. Cappelli (1995) and Cappelli *et al.* (1997) has observed that the long-term commitment of many employers to their employees, including middle managers, has declined. Downsizing, the adoption of more flexible labour contracts, deregulation of the labour market, the reduction of union power and the shrinking of collective bargaining coverage with its emphasis on the common rate, all seem to be moving away from the employment and income security values imbedded within the internal labour market. As new payment systems dependent on strong links between pay and individual performance multiply, the importance of the pay-productivity relationship (at the heart of the standard theory) might be coming back into play. At least this is an area that requires to be watched.

A fourth area which has attracted a good deal of attention involves the economic theory of *agency*. This theory focuses on those forms of payment by which the principal

party (the firm) seeks to motivate the agent (worker) to behave in a manner which is of advantage to the principal. When a principal considers contracting with an agent for the performance of a service, each party has (asymmetrical) information which is private to itself: only the agent knows the true cost of the effort required of him, while the principal knows the (expected) value of the output. In the design of an optimal contract, both face risks – will the agent deliver the required output on time, will the principal pay enough to reward the effort? And what happens if external conditions intervene and frustrate genuine effort on the part of the agent – e.g. weather conditions? This goes to the heart of many compensation problems: how to provide motivation for the agent (for example through incentive payments) or how to ensure that the agent does not shirk or cheat in ways that the principal finds difficult or expensive to monitor: supervision may provide an answer but it too comes at a cost to the principal. One solution for the employer may be to adopt a deferred compensation approach in which employees are paid less than their marginal revenue product in their early years, but more than their marginal revenue product in their later years. Such an approach should reduce both quits and shirking and would be consistent with the observed positive correlation between earnings and tenure. Equally, however, collective incentive schemes such as profit sharing and employee ownership, may improve alignment between employer and employee objectives. As we shall see, the principal-agent analysis also has a bearing on the issue of executive compensation.

## A PART OF THE STORY, BUT NOT THE FULL STORY

A distinguished economist once stated that 'economists were people who thought very seriously about small issues'. Is this a fair and accurate summation of the contribution of labour economists to our understanding of firm-level compensation practices? That is, have they focused on the important, strategic questions concerning compensation at the firm level, and produced useful insights into these areas? To assist our overall assessment in this regard we set out in exhibit 3.4 some of the leading strategic issues involved in firm-level compensation.

With exhibit 3.4 as a reference point, our reading of the economists' contribution to the compensation literature inclines us to the following broad conclusions.

- 1 The body of theoretical literature is considerably greater than the empirical literature.
- 2 The focus has been much more on the *determinants*, rather than the *consequences* of compensation arrangements.
- 3 *Efficiency* is the over-riding theme, though more assumed than demonstrated.
- 4 The level of pay or compensation has been the major research concentration.
- 5 Research on the structure of compensation, the mix of compensation, the criteria or basis of compensation decisions, and the processes involved (see exhibit 3.4) is growing, but is much less than on the level of compensation.
- 6 These generalisations from the American literature hold even more strongly for the literature from other countries.

A number of important implications follow from the above conclusions. For instance, compensation practitioners at the firm level essentially ask themselves the following

### Exhibit 3.4

#### Strategic issues in the design of compensation systems

- 1 *The basis for rewards*  
Is pay to be job based or skills or competence based?
- 2 *Pay for performance*  
Questions here include the extent of performance-based pay, the particular aspects of performance and whether it is based on individual or group performance.
- 3 *Market position*  
How does the reward system compare with that of other organisations?
- 4 *Internal-external pay comparison orientated*  
What should be the relative emphasis given to the attainment of internal or external equity?
- 5 *Centralised-decentralised reward strategy*  
The issue here is the extent to which one seeks to standardise reward systems throughout the organisation.
- 6 *Degree of hierarchy*  
The question here concerns whether an organisation seeks a relatively hierarchical or egalitarian reward system.
- 7 *Reward mix*  
The issue here is the balance between pay and benefits.
- 8 *Process issues*
  - (a) Communication policy: The question is whether a relatively open or closed communication policy concerning reward systems should be adopted.
  - (b) Decision-making practices: The question here concerns the extent or range of individuals involved in the relevant processes of decision making.

Source: Lawler (1984).

questions: What choices do I have to make (see exhibit 3.4); What should influence my choices; and What are the consequences of my choices? Arguably, by concentrating on the determinants, rather than consequences, of compensation decisions, economists run the risk of telling practitioners what they already know. Relatively few practitioners are likely to be surprised by, or find much helpful insight, in studies which tell them that, for example, payment by results systems are more likely when employment contracts are shorter, that the number of supervisors varies inversely with the incidence of payment by results schemes, or that payment by results is more likely to be found in large establishments.<sup>3</sup> Furthermore, because economics takes much less of a contingency-based prescriptive perspective than, for example, the strategic human resource management literature, it is arguably of less interest and relevance in pointing up the factors which shape compensation choices. As a consequence, it is likely to be the economists' contribution to the *consequences* of choices that is of major interest to practitioners. However, as noted earlier, this body of literature is only in its relative infancy. A recent symposium noted the following (Ehrenberg, 1990: 4–5 and 6–9):

- 1 Little empirical testing by economists has been directed at whether pay structures have incentive effects at the individual employee level.

- 2 There is very little empirical evidence that firms pursuing high wage strategies actually outperform other firms.

However, as with any generalisations, exceptions exist. Accordingly we note in the next section two such areas of research by economists which have been of considerable interest to compensation practitioners at the firm level. Indeed the approach involved in these two areas is one which we feel can and should be pursued by economists more widely.

### TWO EXCEPTIONAL CASES: THE WAY FORWARD?

The first area is that of executive or senior management compensation. Studies of executive compensation in the US in the 1970s and early 1980s frequently documented the lack of a relationship between corporate performance and executive pay (Cappelli *et al.*, 1997: 39). Ehrenberg and Milkovich, (1987: 92), interpreted this as evidence that:

corporate executives may pursue objectives such as sales maximization, growth maximization, or market-share maximization that are not necessarily in the best interests of shareholders who are concerned with short-run (accounting profits) and long-run (total stock market return) measures of the economic profitability of the corporation.

The result was the development of a number of theoretical models seeking optimal ways to resolve this *principal-agent* problem (Lazear, 1995). If there is a divergence of interests between the owners of companies and the top directors, the problem for the shareholders is to design contracts that will bring the top executives (agents) into line. In practice, this would seem to involve a larger proportion of stock-based, long-term incentives relative to fixed pay. There is a growing body of empirical research on executive compensation designed to examine the implications of agency theory, namely that an increased alignment of shareholder and executive interests increases the performance of the firm.

A number of existing studies reveal that changes in executive compensation are highly and positively correlated with firm measures of economic performance (Ehrenberg and Milkovich, 1987: 93). However, both the definition of compensation and the measures of economic performance vary across the studies. Moreover, the existence of such a correlation is not in itself evidence of the fact that the compensation-performance linkage has led to improved economic performance. As Ehrenberg and Milkovich put it (1987: 94):

One possibility is that corporations initially don't know what the true productivity of their executives is. However, to the extent that the executives' productivity can be imperfectly *signaled* by corporate performance, relating their compensation to corporate performance is a way of 'paying them what they're worth'. If this is occurring, the compensation-performance nexus could reflect learning about executives' 'true ability' over time, not necessarily any incentive arrangement to stimulate economic performance. Furthermore, even if appropriate incentives *do* exist, it doesn't necessarily follow that they will have their intended effect. Disentangling whether the observed correlation is due to 'incentives' or 'learning' is not an easy task.

Although important issues, such as those outlined in the above quote, remain unresolved, empirical research on executive compensation has already produced some important findings, as indicated in table 3.1.



**Table 3.1 Empirical support for propositions concerning predictors and correlates of executive pay**

| Proposition                                                                                                                                                                                                                        | Empirical support   |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|
| Executive pay varies as a function of firm performance.                                                                                                                                                                            | Very mixed, minimal |
| The more dispersed the ownership of a firm, the more executives will structure their compensation package so that their pay is flexible to move up as firm performance improves, but will not suffer if firm performance declines. | Strong              |
| The more dispersed the ownership of a firm, the more likely executives will be driven to increase firm size, even if additional growth results in decreased performance.                                                           | Strong              |
| The more concentrated the ownership of a firm, the more likely executive decisions will have a long-term horizon.                                                                                                                  | Moderate            |
| Greater monitoring and incentive alignment of executives result in improved firm performance.                                                                                                                                      | Moderate            |
| Greater monitoring and incentive alignment of executives lead to a greater observed linkage between executive pay and firm performance.                                                                                            | Moderate            |
| Relationship between executive pay and firm performance varies by extent of diversification.                                                                                                                                       | Strong              |
| Extent of division autonomy affects criteria used to reward executives.                                                                                                                                                            | Strong              |
| Executive pay is more strongly related to stock-related performance criteria than to accounting measures.                                                                                                                          | Negative            |
| Executive decisions are very responsive to what incumbents perceive will lead to the greatest financial reward.                                                                                                                    | Very strong         |

Source: Gomez-Mejia, Paulin and Grabke (1995).

Research on executive level compensation and its relation to corporate performance has been growing in the UK.<sup>4</sup>

- 1 The UK evidence points to the existence of very small pay-performance sensitivities, suggesting that the incentive link is not strong; and more recent evidence post-1988 could not detect any relationship between the basic pay of UK executives and the stock market performance of their companies.
- 2 However, more recent work which separates out executive salary from bonus payments suggests that salary is strongly related to company size, while annual bonus is 'moderately' associated with size and performance (McKnight, 1996: 557–66).
- 3 There is strong evidence that managerial incentives are not closely aligned to those of shareholders and this leads to significant under-performance in the corporate sector, in particular because of poorly judged acquisitions (Curcio, 1992).

Given the continuing controversy about executive pay levels in Britain we see this as an area that warrants continued research, not least for its implications for corporate governance issues.

The second area of research by economists which we would draw attention to has been in relation to profit-sharing schemes. Economists have taken the lead in arguing

that such schemes can enhance organisational performance and, if widespread, can be an important source of overall employment stability at the macro-economic level (Weitzman, 1984). Moreover their empirical research has yielded consistent evidence of significant, positive links between the existence of profit-sharing schemes and organisational performance, usually defined as value added (Weitzman and Kruse, 1996). Admittedly, reservations and criticisms have been expressed about some elements involved in this particular stream of research. For example, important questions have been raised about the appropriateness of the variables used in the studies, the lack of explicit attention given to the precise mechanisms involved and the difficulty of establishing clear-cut lines of causation. Nevertheless we would argue that it is the direction of this research that has been particularly important and worthwhile. Economists in this particular area have focused on the firm level of analysis, been concerned with the consequences of the arrangements and have often broadened their frameworks of analysis to include process variables which have traditionally received little attention in their work. For example, one can now find economists concluding that employee participation and contingent compensation, taken together, produce stronger positive organisational performance gains than each can achieve individually (Levine and Tyson, 1990; Kruse, 1996).

## CONCLUSION

The themes treated in this chapter serve to demonstrate that there is no single orthodoxy among economists in their approach to the study of compensation. It is also clear that many of the concerns of economists in this area, notably the focus on overall economic efficiency and the stickiness of wage response to environmental change, are far removed from the concerns of managers and human resource practitioners who view remuneration as a management tool, amongst others, which can help deliver organisational objectives. We have seen that much of the economist's interest focuses on industrial and occupational dimensions, rather than on the inter-firm analysis of compensation policy and practice, though we have noted growing interest in this dimension. Yet the central issues for many companies, their ability to attract and retain suitable labour, their capacity to motivate workers to deliver what the company wants, and the well-recognised social concern within the work place for equity in compensation, are not exactly at the top of the economist's agenda.

This does not mean, though, that we should write off the economists' contributions as irrelevant. In the first place, it is important to be reminded that, even though many firms are able to exercise considerable discretion in their remuneration strategy, both the product market environment and the labour market environment will set limits which cannot be ignored in the formulation of strategy for the business and for the management of the human resource.

Second, the opening up of discretionary decision making, rather than simple acceptance of a ruling market wage rate, still seems to leave considerable scope for analysis at the level of the firm. Human capital theory reminds us that human capital is embodied in individuals who have free will and can move with that capital intact, even if its acquisition has been largely at the expense of an employer. And agency theory returns us to the familiar problem that worker performance is not something that can be guaranteed by the presence of a labour contract. Performance needs to be



elicited and refreshed in a variety of ways which leaves considerable discretion in the design of compensation: this applies both to the elimination of shirking (a negative element) and to the encouragement of continued development and application of firm-specific skills and experience in the pursuit of organisational goals (a positive element). Enough has been said in the course of this chapter to illustrate the range of reward systems which have the potential to deliver these goals, but they fall far short of any recipe or 'one best way'. Rather they underline the need for good analysis of goals and an understanding of alternative means of achieving them, whether through the reward mechanism directly or the reward mechanism in association with other management tools. Where economics can make further contributions to this is particularly in the development of research into the effectiveness of different combinations of reward and other management policies at the level of the firm.<sup>5</sup>

Finally, the economic analysis of efficiency wages, internal labour markets and principal-agent relationships for the design of the optimal contract, though they do not constitute a coherent theory, provide a framework for the understanding of pay related to many of the behavioural and organisational variables which are of interest to the practitioner. If these links are to be further developed they would seem to require more of what Thaler (1989: 190) calls 'micro-micro' (nano?) economics:

Economists would have to get their hands dirty collecting data on the actual operation of organisations. Unless the profession is willing to reward this type of time-consuming research activity, many important questions will remain unresolved.

## NOTES

- 1 See below, p. 54.
- 2 But see below.
- 3 See Heywood, Siebert and Wei (1997).
- 4 For a summary, see M. Conyon, P. Gregg and S. Machin (1995).
- 5 For a good example, see Kruse (1996).

## LEARNING ACTIVITIES

- 1 Critically evaluate the standard classical approach to the economic theory of pay.
- 2 Identify the insights into the design and management of reward systems offered by more recent approaches to economic theories of pay.
- 3 Identify the factors that might impact on the future demand for and supply of labour to the employment market.
- 4 How might the factors identified in question three impact on organisational reward systems?

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## 4

# Economic policy, the labour market and reward

Catherine Kavanagh and Robert Elliott

## INTRODUCTION

For almost two decades now, the thrust of economic policy towards the UK labour market has been to enhance labour market flexibility. This has substantially increased the freedom of companies operating in the UK to construct and implement reward strategies that meet their needs. The change in government that occurred in May 1997 seems unlikely to substantially change these developments (although some greater measure of labour market regulation is encouraged with the introduction of a minimum wage). The policies implemented to achieve this objective have been many and diverse and, thus, this chapter ranges wide.

The substantive change in policy toward the labour market dates from 1979. Most of the reforms were carried out during the 1980s by the Conservative government under the leadership of Margaret Thatcher. Thatcher's fundamentally different economic strategy consisted of two major elements. The first, on the demand side, was to pursue a policy of firm monetary control in order to reduce inflation. The second was to pursue radical market-orientated supply-side policies. The main thrust of these market-orientated supply-side policies was to encourage and reward individual enterprise and initiative, to reduce the role of government, and put more reliance on market forces and competition and less on government intervention and regulation.

In the labour market, the UK programme of reforms focused on promoting flexibility. To attain a more flexible labour market, successive governments sought to reduce as much as possible all restrictions on the deployment of labour, whether from unions, employers' organisations or protective legislation giving workers rights either at work or against its loss. Deregulation and decentralisation replaced incomes policies and, in some cases, collective bargaining agreements. There has been a large drop in union presence and, even in the unionised part of the private sector, national- or industry-level pay agreements have all but disappeared. In the private sector, pay is now more likely to be set within the firm or the work place. The central aim of successive administrations has been to restore the initiative to employers (as opposed to unions or the government itself). In so doing, the concern is to ensure that employers' freedom is strongly structured by market incentives.