PERSONNEL NOTEBOOK

For Your Most Important Resource — The Human Resource

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MYTH BUSTERS ABOUT PAY

For most companies, their understanding about pay is pretty simple. Keep your labor rates low and profits high and you've got a long-term winning formula. We would assume that if construction company A is paying an overall average of $25.00 per hour and construction company B is paying $28.50 per hour, then company A has a lower labor cost and should be making higher profit. But is this true? Is lower individual pay the key driver for profit?

Actually, when we look at what is happening in the marketplace, we find that companies that base their success on paying the least are seldom industry leaders and do not survive for the long term.

Some companies believe just the opposite, that the higher the pay, the more profitable the company is likely to be. Is that true? Are employees primarily motivated by pay?

Actually, national surveys asking employees to rank the most important things in their jobs rarely list pay in the top 10 items. Pay is on the list but is usually among the lower-ranked items.

So, what's the answer, high pay or low pay? Are both positions wrong? Are they myths?

The decisions employers have to make about compensation include:

- How much to pay employees.
- How much emphasis to place on *financial* compensation as part of the *total compensation* system.
- How much emphasis to place on holding down the rate of pay.
- Whether to implement a system of individual incentives to reward differences in performance and productivity, and if so, how much emphasis to place on those incentives.

Company leaders know that such decisions cannot simply be delegated down. Pay strategy is a companywide issue and must be decided as a companywide strategy.

For example, when Quantum, the disk drive manufacturer set its compensation strategy, it placed all employees, from the CEO to each and every hourly employee, on the same bonus plan, and that plan is

based on the same measure for all; the return on total capital (ROTC).

Dr. Jeffrey Pfeffer is the Thomas D. Dee Professor of Organizational Behavior at Stanford University and the author of *The Human Equation: Building Profits by Putting People First.* Following are his top six myths about pay:

Myth No. 1: Labor rates and labor costs are the same thing.

The Reality — The two are actually very different. It's productivity that really matters not pay rate.

Example — In the late 1990s, General Motors (GM) tried to boost profits by moving work to lower-paid plants. They, however, failed to focus on productivity. It took GM 46 hours to assemble a car, while Ford needed only 38 hours, Toyota 29 hours, and Nissan 27 hours.

GM entered into a joint venture with Toyota in California. Together they paid wages approximately 10 percent higher than industry averages. And, because of their focus on efficiency, team rewards, and a change in culture, their productivity rose 50 percent, thereby creating a lower labor cost.

When two competitive steel mills were analyzed, it was found that company A was paying almost $4.00 per hour more than company B. Yet, company A produced more tons of steel for the amount of money they spent. The result was that company A was the lower bidder on most competitive contracts. It actually could have increased the hourly rate by 19 percent and still have been the lower bidder.

Labor rate can be defined as total salary divided by the amount of time worked. *Labor cost* can be defined by dividing the total output (number of units) by the number of dollars it took to produce it.

Myth No. 2: You can cut labor costs by cutting labor rates.

The Reality — Labor costs are a function of both labor rates and productivity.

Example — When Cincinnati Milacron (CM), a struggling machine tool company, overhauled its production processes, it slashed labor hours by more than 50 percent without lowering wages.

CM virtually had surrendered the market to low-end Asian competitors and was contemplating cutting labor wages. Instead, it overhauled its assembly process, abolished its stockroom, and reduced job categories through cross-training from seven categories to one. That's how the more than 50 percent reduction in labor hours was accomplished. And this was done without *any* capital investment. CM's productivity then outperformed all its Asian rivals.

If a company replaces its $2,000 a week engineers with some that earn $500 per week they might expect to see profit margins soar. But if the new employees are inexperienced, slow, prone to making mistakes, and less capable, costs will likely soar instead.

Myth No. 3: Labor costs are a big part of total costs.

The Reality — The ratio of labor and total costs varies widely across industries and across companies within the same industry.

Example — In the U.S. apparel industry, the manufacturers' labor costs to make a pair of jeans is just 15 percent of the total costs. A man's suit has a total labor cost of approximately $15.00.

Wal-Mart is not the largest and most successful employer in the U.S. because it pays low wages. It actually pays more than most similar retailers for the same skill set. It's Wal-Mart's purchasing, marketing, and, above all, its distribution system that revolutionized the industry. Its efficient use of employees also accounts for the company's spectacular growth. Wal-Mart employees are carefully selected, well trained, and highly motivated, and management works diligently to keep its turnover rates low.

There are, of course, some cases where labor costs truly are a significant portion of total costs, for example in accounting and consulting firms. However, even there the impact is not nearly as important as many managers believe. It still comes down to productivity and measurable results.

Myth No. 4: Low labor costs are a meaningful competitive strategy.

The Reality — Lower labor costs are perhaps the least sustainable competitive advantage.

Example — Men's Wearhouse, a major, nationwide clothier, pays above-industry wages and invests extensively in training. It competes on customer service, superior product knowledge, and sales skills. These are advantages that rivals cannot easily copy.

The issue isn't what its employees cost, it's what they can do; sell very effectively because of their product knowledge and sales abilities. Moreover, higher, faster sales keep the company's inventory low and it saves money on inventory shrinkage as well as hiring.

Many companies that consider low wages to be their primary competitive strategy may neglect other, more effective ways to compete, such as quality, service, delivery, and innovation. In reality low labor costs can be a rather shortsighted way to compete and is perhaps the least sustainable.

Myth No. 5: The best way to motivate employees is through individual merit pay.

The Reality — Group-based compensation reinforces collaboration and team spirit far more than individual pay does.

Example — When an exhaust system manufacturer replaced its piecework system of compensation with group-oriented compensation, grievances evaporated, product quality jumped, and teamwork intensified.

It's true that, "Whatever you reward, you get more of." If the results you seek for your company can be produced with one person, then reward that person and you will get more of what he or she does. But if the results you seek require a combination of skills, the efforts of many, the cooperation and timing from a team, then reward the team. That way you'll get more teamwork.

Myth No. 6: People work primarily for pay.

The Reality — People work primarily to be in an environment that's enjoyable, challenging, respectful, and lets them use all their skills.

Example — Software company SAS Institute maintains a less than 4 percent turnover rate in a very tight labor market that normally experiences a 20 percent turnover. How? Employees value the intellectually engaging work, access to cutting-edge equipment, smart, funny colleagues, a family-friendly environment, and SAS's clearly expressed appreciation.

At Xerox Corp. in Rochester, New York, Bill Strusz director of corporate industrial relations says, “If managers are using money as the primary tool to improve productivity or to solve organizational problems, there will be two results. Nothing will happen and you’ll spend a lot of money.” That’s because people want more out of their jobs than just money.

Numerous surveys, even of graduates with huge college loan debt, indicate that money is far from the most important factor in choosing a job or remaining in one. Professional recruiters have often said, “You might be able to bring in a candidate with money, but money alone won’t keep the good ones.”

Many factors actually carry more weight with employees, including high-ranking items such as:

- Being treated like responsible adults.
- Interesting, challenging work.
- A feeling of belonging and of being valued.
- Being able to express ideas and be heard.

People seek an enjoyable work environment.

Why do these myths persist?

Some say it’s the way they’ve always done it and business schools still teach it that way. According to the global magazine *The Economist,* it’s because most managers find it a lot easier, quicker, and flashier to cut wages than to change corporate culture, create new, efficient systems, streamline production, and alter product design. Labor costs seem to be the closest lever at hand.

Such a model assumes that employees will always see work as hard, unpleasant, and to be avoided. It also assumes that they can be seduced to work by money alone. In reality, almost everyone would rather be involved deeply in the work they do well and enjoy accomplishing with people they respect and who respect them.

Pay is just one element in a set of management practices that can either build or reduce commitment, teamwork, and performance. Competitive pay, benefits, and culture are all part of the total compensation package.

If you view your people as a cost, you will try to minimize them. If you view them as an investment, you will try to develop and maximize them.

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