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Motivating With Efficiency Wages and Delayed Payments

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My family and I recently spent a week in Cape Cod, Mass., on vacation. On our way back to Ithaca, N.Y., we stopped for lunch. The first half of my fast-food salad was delicious; I was really impressed with it ... until I found the insect. I showed the restaurant manager, handed him the receipt and asked him if he could help me. (The guy next to me in line asked, "Was it moving?" as he stuffed fries in his mouth.) The manager apologized, returned my money and gave me some coupons for free drinks. I kept my meal with the extra protein and plan to have some entomologist friends tell me more about the bug. This all got me to thinking about a few specific aspects of why people are paid they way they are. (The connection will become clear as you read on.)

Economists (and even normal people) sometimes assume that employees may not always do things in the best interest of the company for which they work, and may even loaf, stall, waste time or generally be lazy at work. (Of course there is a large body of work on the distinctions between extrinsic motivation [imposed by others] and intrinsic motivation [self-generated], but for now, let's think about the case where the organization is worried that the worker might be tempted to not work particularly hard.) Stanford University economist Edward Lazear suggested 30 years ago that companies could motivate workers to work hard year after year by paying them less than the value they create for the company early in the workers' tenure with the company and more than the value they create for the company later in the workers' tenure. Workers would then be motivated, year after year, to work hard and not get fired in order to reap the higher wages in the long run. This kind of compensation system, let's call it the delayed payment method, is efficient in the long run because the relatively low early wage and the relatively high late wage cancel each other out.

However, due to minimum wage or other constraints, companies may not have the option to pay the lower wage early. As a result, it may make sense for companies to pay what economists call "efficiency wages." In this case, workers are essentially paid a wage that is higher than the next-best offer they could get. While you might think this would be a bad business decision on the part of employers, it may be perfectly sound for a number of reasons. First, paying workers more than their next-best alternative may lead them to be careful not to slack off for fear of

losing their job, if caught slacking, and having to work elsewhere for less money. Second, paying an efficiency wage premium may result in being able to attract the more capable workers. This is especially useful in an organization where it is difficult to monitor workers and keep track of what they are (or are not) doing.

Fast Food

So what does this have to do with my high-protein salad? A paper by Princeton economist Alan Krueger tried to sort out delayed-payment versus efficiency-wage methods using data from the fast-food industry. He did this by cleverly comparing restaurants that are company-owned to those that are franchised. Among the many insights in his work, Krueger found that managers in company-owned establishments have less incentive to monitor workers than managers in franchised outlets, in particular because the managers in the company-owned establishments get less of the extra profit from their location than managers of otherwise similar franchised outlets. In other words, managers of company-owned establishments are less likely paid on profit and not as easily observed by the parent company compared to managers of the franchised locations.

Statistical results in Krueger's paper revealed that at company-owned restaurants, employee compensation is higher and the delayed payment profile is steeper than at franchised outlets. That is, the pay at company-owned restaurants is "backloaded to provide an incentive against shirking." He ends his 1991 paper by noting that there is actually a lot of monitoring of workers (even by customers) in the fast-food industry; perhaps this issue could be examined in other industries where employee effort is harder to monitor, including in hotels.

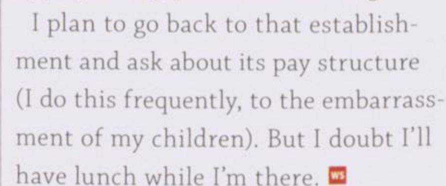
Hotels

Jump forward 20 years from Krueger's paper. (I do know that the academic world doesn't move as fast as most of the rest of the world). Two of my Cornell colleagues, Matthew Freedman and Renata Kosova, have just completed research studying hotel chains, where it is a lot more difficult to observe whether employees are working hard. Hotels, unlike fast-food restaurants, can be enormous, with workers doing their jobs in isolation. These authors observed the same hotels over many years and even observed hotels that switch from one organizational form to the other, making this paper particularly interesting and convincing.

Freedman and Kosova found that company-owned hotels are more likely than franchised ones to advertise wages above minimum wages, but are also more likely to use lower probationary wages. The authors found evidence of the delayed-payment method in franchised hotels. They also found, however, that since franchised hotels do more monitoring of workers (and better measure performance), they are better able to pay for performance.

This research on hotels and fast-food restaurants shows that how closely workers can be monitored, the degree to which managers share in profits, and the timing of pay and other attributes of employee compensation design are inseparable.

In my case, the salad with the bug was prepackaged and served in a franchised outlet. The monitoring of its creation was likely done on another shift, if not at a completely different location, by an employee perhaps unknown by the manager with whom I spoke. The current manager didn't seem to want to do much more than refund me the cost of the salad (but not of the other food my family did not finish eating after my discovery). Was this manager's pay poorly designed, or appropriately profit-maximizing?



I plan to go back to that establishment and ask about its pay structure (I do this frequently, to the embarrassment of my children). But I doubt I'll have lunch while I'm there.

The Institute for Compensation Studies (ICS) at Cornell University analyzes, teaches and communicates about monetary and nonmonetary rewards from work, and how rewards influence individuals, companies, industries and economies. ICS research and leading-edge insight address compensation issues challenging employers and employees in today's dynamic global marketplace.

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