More on Compensation

• Compensation based on inputs or outputs
  – Pay by the hour or
  – Pay by the job

Inputs or Outputs

• Pay by Inputs
  – You get paid by the hour or month
• Pay by Outputs
  – You get paid by output.

Piecework

• Piecework seems the way to go where it is easy to measure productivity.

Piecework

• Piecework seems the way to go where it is easy to measure productivity.
• There are situations where monitoring is quite difficult.
  – Suppose you pay a lettuce picker by the pounds of lettuce picked.
  – Workers will not look at the quality of heads and will overlook smaller heads.
**Piecework**

- **Output is stochastic.**
  - A salesman's success depends in part on skills and motivation (which argues for piecework) and in part on factors beyond his control.
  - A risk-averse salesman will prefer not to be paid on output.

**An aside**

- Any waiter or waitress would prefer to work weekends: the tips are better.
- A sensible restaurant requires that all wait staff work weekdays as well.

**Using Wage Policy as an Incentive Mechanism**

- Suppose I have employees whose performance is difficult to monitor.
- Pay a premium, where they lose the premium if they are caught mis-performing.
Using Wage Policy as an Incentive Mechanism

- Suppose I have employees whose performance is difficult to monitor.
- Pay a premium, where they lose the premium if they are caught mis-performing.
  - Police officers
  - McDonald’s Franchises
  - Bank Tellers

An Example

- John Smith and Bill Wilson are both product managers for Baker Electronics.

An Example

- They know that when a senior product manager’s slot opens, it will be filled by “promotion from within”.

An Example

- That way they are best motivated to do their job.
  - Smith and Wilson can be paid the same salary, even though Smith is a better worker.
  - There will be a little griping about salary, but Smith will get his reward through a promotion.

An Example

- Now suppose that it appears that Smith is the better worker, but it may take a year or two before that is clear.
- Smith has brought in all sorts of profitable clients for the firm. He deserves a reward of (say) $25,000 for that.
- It may turn out however that the clients will turn out to be unprofitable, perhaps because Smith made promises that can be kept only at high cost.
An Example

• Why not give Smith a promotion and a $5,000 a year increase in pay? If it turns out a year from now that Smith screwed up, he can be fired.

• There is a drawback. Smith and Wilson may need to work together, and the opportunities for “back-stabbing” seem to grow when they are competing for the same job.

Summary

• We have only scratched the surface.
• Compensation policy would be easy if we could monitor performance at no cost.
• We cannot, so it becomes more complicated.

End

©2003 Charles W. Upton