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Efficiency Wages as an Alternative to Using Personal Economic Incentives

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Abstract: The article discusses the concept of "effective wages" and the advantages of using this approach when paying employees of an organization. A comparative analysis of two approaches to stimulating workers was carried out – the introduction of effective wages and the use of individual economic incentives.

Keywords: Efficiency Wages; Individual Economic Incentives; Employees; Motivation; Factor; Benefits; Efficiency

1.Introduction.

In their renowned tome titled "Quest for Eminence," Peters and Waterman acknowledge 'productivity through personnel' as one of the eight attributes of a distinguished enterprise, necessitating a highly impassioned and engaged workforce. To a greater or lesser extent, any model of business distinction embodies this criterion. In order to invigorate employees, numerous enterprises resort to pecuniary remuneration. While some scholars dispute the motivational efficacy of wages, there exists ample corroboration attesting to the potency of money as a formidable motivator.

Money satiates the requisites of Maslow's hierarchy of needs, concurrently symbolizing one's societal standing and thereby recognizing individual accomplishments. Hence, it is commonplace for enterprises to adopt wage policies grounded in economic incentives, particularly those tethered to individual performance, yielding customized payrolls commensurate with elevated remuneration and linked to heightened output or results. By and large, it is presupposed that such incentives impel individuals to toil more assiduously, concurrently harmonizing personal interests with organizational objectives.

2.Main part

Effective wage – a wage that is set by the employer at a level above the equilibrium level in order to encourage the employee to work as efficiently as possible.

The term "efficiency-wages" was first introduced by A. Marshall in "Principles of Economic Science" (Marshall 1993). He noted that wages are "measured according to the worker's performance of the dexterity and productivity required of him," and employers pay higher wages to workers whose work is more efficient than other workers due to individual differences not due to technical equipment or other factors not related to the personal characteristics of the employee.

In modern economic theory, effective wages are considered as:

- a way to solve the problem of information asymmetry between employer and employee;
- a way to reduce staff turnover costs;
- a way to increase worker productivity and thereby increase company profits.

In the first case, the problem of information asymmetry between the employer and the employee is solved, which is caused by the difficulty of measuring the specific abilities and labor efforts of the employee and establishing wage standards in accordance with them, which creates the opportunity for the employee to evade performing work in the full agreed volume.

In the second case, when effective wages act as a tool to reduce the costs of employee turnover, setting higher than market wages motivates workers to continue working for a given employer and reduces incentives to look for work in other companies. This reduces the costs associated with staff turnover, in particular the costs of training newly hired employees.

In the third case, the company, by setting effective wages, solves the problem of increasing worker productivity and thereby increasing profits. Effective wages, set above the equilibrium level prevailing in the labor market, attract more productive workers to work in a given company, which has a positive effect on the productivity of the company's employees as a whole.

Economists have extensively probed efficiency wages, not only propounding diverse explanatory theories but also scrutinizing their impacts on both macroeconomic and microeconomic indicators. However, there is a paucity of literature examining efficiency wages from the perspectives of managerial or employee behavior. Efficiency wages are a powerful alternative to individual economic incentives. It can be argued that efficiency wages provide commensurate positive results as an incentive. Substantiation for this contention is found in experimental economics, which depicts efficiency wages as a pre-paid incentive; and behavioral economics, which asserts that to avert losing this incentive, employees will exert themselves to enhance their performance. However, effective pay does not inherently direct the behavior of company employees towards achieving organizational goals, which requires establishing informative feedback to find a way to improve staff performance.

The contemplation articulated in this manuscript enables us to portray efficiency wages as an efficacious instrument for attaining a pivotal facet of any business model: human resource planning and its holistic engagement in the development of the company.

A remuneration serves as a recompense for exertions rendered. The aim of inducements is to not only spur employees to toil more ardently but also engage them in the attainment of organizational objectives. The foundational belief lies in the premise that pecuniary incentives act as motivators for individuals, and given that motivation profoundly influences performance, economic incentives stand as the most potent motivational impetus.

Deftly devised and implemented incentive frameworks have the potential to augment organizational efficiency. Three rationales substantiate such a deduction. Firstly, incentives exhibit a robust and affirmative impact on the vigor and continuity of employees' exertions, known as the 'effort' effect, instigating heightened diligence in task execution. Secondly, the presence of substantial incentives serves as an enticement and retention mechanism for top-tier employees while prompting underperforming ones to exit the organization, termed the 'sorting' effect, significantly influencing the efficacy of incentives. Lastly, the utilization of incentives dictates that employees channel their efforts toward the realization of organizational objectives, an 'direction' effect that inherently implies an enhancement of performance. Even if incentives were to fall short in eliciting greater individual exertion, they would, at a minimum, foster more qualitative efforts by concentrating on objectives pursued by the organization. It's noteworthy that, despite incentives escalating total payroll expenditures, labor unit costs decline as overall productivity increases at a greater proportion.

Each enterprise must gauge the success of the three aforementioned effects in terms of its overall performance. To achieve this goal, it is necessary to develop key performance indicators by measuring the level of productivity of employees, educating employees on various aspects related to productivity, and checking whether their performance dynamics are in line with the strategic goals of the organization. Although there are many KPIs available, each company must develop its own set of KPIs.

Despite the aforementioned, incentives might yield consequences contrary or divergent from expectations. Frequently, economic incentives can either deter desired behaviors of employees or promote different ones, offsetting the positive outcomes of the three aforementioned effects. This distortive impact of incentives is inseparable from their motivational essence. Incentives may dissuade individuals from undertaking risky endeavors that embrace novel challenges simply because their focus is not on analyzing new ideas but on attaining immediate rewards. When individuals are informed of an impending tangible reward, their focus tends to shift more toward achieving the reward than executing the task proficiently. In this regard, incentives become counterproductive when task outcomes are expansive and open-ended, with the necessary steps to a solution not being apparent. Incentives also steer employees' attention toward short-term gains and narrow numerical objectives, diverting them from pursuing the long-term prosperity of the firm, potentially leading to dysfunctional outcomes.

Typically, individual incentives are founded on the misguided perception that organizational effectiveness results from a simple additive combination of disparate individual performances. This viewpoint disregards the value, relevance, and nature of collective interactions. Furthermore, the use of incentives neglects the fact that individual performance can be the outcome of an exchange of ideas and resources with other colleagues, overlooking the existence of indirect contributions within a broader exchange ecosystem. Therefore, another significant disadvantage they have is collaboration. Incentives discourage cooperation because time spent helping a colleague reduces the helper's absolute effectiveness. According to Deming, lack of collaboration results in poor product quality: a notable disadvantage in today's work environment, characterized by tasks that often require collaboration.

Economic incentives tied to individual results also give rise to pay dispersion among employees. The higher the intensity of incentives, the greater the pay dispersion. Some firms contend that only a small fraction of their workforce merits incentives. While deemed fair by some, others posit that pay dispersion fosters frustration in the workforce, perceived as unjust, potentially contributing to low morale, heightened job turnover, absenteeism, and diminished quality of goods and services. Employees might even be inclined to engage in theft or sabotage.

When using incentives, there is a risk of not achieving planned indicators. Nevertheless, employees might perceive themselves entitled to a minimum monetary sum for the exertions made, causing discomfort and feelings of abandonment for any payments below this threshold. In practice, not receiving the anticipated reward has a comparable effect to punishment, potentially evoking negative emotions and antisocial behaviors.

The assumption that employee performance is within their control and, consequently, individual actions drive to intended results justifies the use of incentives to motivate employees. However, results are frequently beyond the complete control of employees. Performance often hinges on enforced leadership, job design, or other factors beyond an employee's full control.

Consequently, through incentives, employees may receive disparate earnings for the same effort and working conditions. Typically, results may depend on factors unrelated to the incentive set, factors independent of employee effort, intelligence, honesty, or diligence while performing tasks, thereby creating uncontrollable risk for employees that creates dissatisfaction and feelings of injustice.

Matching employee effort with fair compensation is a daunting task for any company. This challenge often leads to the use of variable pay and personalized payrolls, considering both professional categories and individual performance. However, implementing incentive-based compensation tied to specific goals is not always straightforward, and many firms fail to achieve their main objectives – motivating staff and aligning their interests with organizational goals.

We believe that efficiency wages can be an effective alternative to incentives. Drawing on behavioral economics, we argue that despite being fixed, efficiency wages act as a prepaid incentive. They motivate employees more effectively than individual economic incentives, thanks to the endowment effect and the reciprocity rule. Higher wages not only attract top talent but also boost morale, foster cooperation, and contribute to organizational harmony. Efficiency wages produce positive effects similar to individual incentives but minimize associated risks.

Conclusion. Efficiency wages discourage undesirable behaviors and reduce the risk of diminished motivation, morale, and loyalty. However, it's crucial for managers to understand that simply paying efficiency wages doesn't ensure employees are aware of objectives and expected behavior. To align employee efforts with organizational goals, informative feedback and recognition are essential when implementing efficiency wages as substitutes for individual economic incentives.

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