HR must argue for strategic salary hikes

Companies often confuse pay reductions with cost reduction. But contrary to popular opinion, pay reductions are more likely to drive costs up or profits down instead. There are other, better ways of achieving the same objective

By **Jeffrey Pfeffer** & **M Muneer**

Enterprises, and even governments, often seek to hold down the pay of employees in an effort to reduce costs. This effort to reduce costs by cutting pay long predates pandemic "lockdownomics" and won't disappear when the pandemic ends.

Post 9/11, when the airline industry experienced a large decline in demand for travel, almost all US airlines except for Southwest not only had layoffs, but obtained large wage concessions from their workers. When US-based automakers struggled to turn a profit, they negotiated two-tier wage structures where new employees would make less money. The recession of 2008 accelerated this trend. According to the NYT, pay cuts, sometimes the result of downgrades in rank or shortened workweeks, are occurring more frequently than at any time since the Great Depression. Pay for the average worker remains constrained today, possibly one explanation for the worldwide ongoing financial stress and political turbulence.

But contrary to what many leaders, analysts and HR professionals seem to believe, employees' rate of pay is not synonymous with labor costs (which reflect not just the rate of pay but also productivity). Moreover, labor costs have little bearing on competitiveness or profitability. Many companies in the IT industry pay very well, but, because of their business models, are extremely profitable. But lower wages do lead to ill health and financial stress, indicators of diminished well-being.

Evidence suggests that if companies paid more, not only would they help their employees but also they would actually help themselves. Here's the logic.

Higher pay for higher productivity

In 1914, Henry Ford introduced a $5 per day wage at the Ford Motor Company, more than doubling the prior rate of pay. According to Robert Lacey's book, Ford: *The Men and the Machine*, the move aroused the ire of The *Wall Street Journal,* which accused Ford of "economic blunders if not crimes." The result of the higher pay: diminished turnover, higher quality workers and higher productivity and profits.

About 100 years later, Dan Price, CEO of Gravity Payments, generated mammoth publicity—and skepticism from Fox Business—when he announced a $70,000 annual minimum wage for Gravity's employees. The much-talked-about move drove customer leads through the roof, and Gravity, a relatively small company of about 200 employees, received thousands of employment inquiries. Profits have never been higher.

These are not just interesting examples. They're consistent with fundamental ideas in economics. The principle of efficiency wages refers to paying above market to improve workers' productivity levels. As economist Lawrence Katz explained, "High wages can help reduce turnover, elicit worker effort, prevent worker collective action [unionization], and attract higher quality employees." Evidence suggests that with more motivated and higher quality workers, less supervision is required because the employees are less likely to shirk responsibilities and are more qualified, thereby saving on supervisory costs.

Because of the profit-enhancing, cost-reducing effects of higher wages, in the end, paying more might actually reduce labor costs. Higher wages can, therefore, actually pay for themselves.

A contemporary illustration of this phenomenon can be seen in University of Colorado professor Wayne Cascio's detailed

Employees' rate of pay is not synonymous with labor costs, and moreover, labor costs have little bearing on competitiveness or profitability. But lower wages do lead to ill health and financial stress, indicators of diminished well-being

comparison of Costco with Wal-Mart's Sam's Club. As Cascio documented, Costco pays higher wages and offers more generous benefits than Sam's Club, making its labor costs higher. But turnover at Sam's Club was 44 percent, while it was only 17 percent at Costco, saving literally hundreds of millions of dollars on replacing employees. He went on to explain that, "Costco generated $21,805 in U.S. operating profit per employee, compared to $11,615 at Sam's Club," meaning that Costco's more experienced, more

productive workforce more than offset its higher cost.

While similar detailed studies could not be found in India, a quick study of private sector banks revealed some interesting aspects unique to India. HDFC has the highest per employee revenue among all banks and its critical job families driving the business have higher wages than the industry average. ICICI Bank, a comparable private sector bank, has higher overall wage bill but less productive, perhaps because it didn't look at the concept of strategic job families, typically 10 percent of all employees, who are most essential to driving the strategy.

In the IT industry, an analysis of top 5 players revealed that Infosys paid higher to employees and led per employee revenue as compared to the next two high productivity firms—Wipro and TCS. Unlike in the banking sector, the direct correlation between higher wages and higher productivity is evident here.

In labor markets, as in many other markets, you get what you pay for, it appears.

Minimizing employee costs should not be a company's primary objective. In many instances, even in contract manufacturing, labor costs are a relatively small proportion of total

The principle of efficiency wages refers to paying above market to improve workers' productivity levels. Evidence suggests that with more motivated and higher quality workers, less supervision is required because the employees are less likely to shirk responsibilities and are more qualified, thereby saving on supervisory costs. Higher wages can, therefore, actually pay for themselves

costs, unless it is in the knowledge economy companies. Spending a lot of time trying to reduce costs of something that accounts for a small proportion of total costs is misplaced emphasis.

Companies are much more interested in maximizing their profits, the difference between revenue minus expenses. Profits come from product and service innovation, productivity and outstanding levels of customer service that generate customer loyalty—all things produced by

a workforce that is engaged and cares.

So what happens when those factors are missing? The airline industry, with its almost omnipresent wage reductions and conflict with employees, serves as a cautionary example. Joe Sharkey, the former *New York Times* travel columnist reported that a survey by the Travel Industry Association "found that the consensus among travelers was that air travel was bad and getting worse." As a result, fed-up fliers deferred 12 million business trips and 29 million leisure trips, costing the airlines the revenue from these 41 million foregone journeys.

What can HR do?

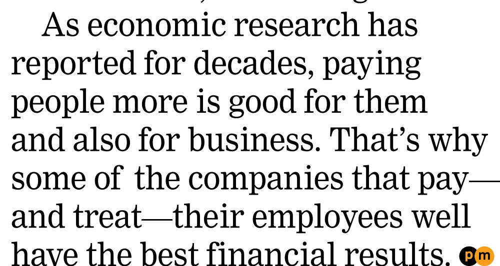
HR executives should take the lead in bringing these higher wage arguments and the associated evidence to senior management so that companies can make more sensible decisions concerning pay levels. It's also worth noting that the arguments about holding down wages somehow never apply to the C-suite, where the ratio of CEO to average employee pay has soared over the past few decades. However, the importance of recruiting and retaining talent extends beyond executives to the entire workforce, which is why paying more can pay off, and HR teams should be championing this notion.

To be fair, high pay is only relative compared to what competitors are offering, which is why if every company tried to put this advice into practice, it wouldn't work. But given the overwhelming tendency to think that simply reducing

labor costs will increase profits, this is not a concern we would worry about. After all, few auto companies followed Ford's lead, and we don't see lots of payment processing companies emulating Gravity Payments.

HR can also examine the HDFC or Southwest model of identifying strategic job families and paying them higher than industry average to attract and retain the best talent who will drive higher per employee revenue. Since the strategy of every company will be different, the concept will hold well for most, if done right.

As economic research has reported for decades, paying people more is good for them and also for business. That's why some of the companies that pay—and treat—their employees well have the best financial results.



ABOUT THE AUTHORS

DR PFEFFER is chair professor of organizational behavior at Stanford Graduate School of Business, and **DR MUNEER** is MD of CustomerLab and Co-Founder of the non-profit Medici Institute.