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FLEXIBLE COMPENSATION
WHEN COMPANIES DEVISE SALARY SCHEMES THEY USE BLUNT INSTRUMENTS - BUT THEY SHOULD BE USING A SCALPEL. BY DAN ARIELY

ne of the largest line items for most companies is employee compensation - in fact, I doubt that there is any company where this is not true. Given this, you would expect companies to pay attention, money and time to figuring out how to pay people in a way that will optimise their earnings and motivation. For example, companies should work out how much they should pay different people in different jobs. How much of the compensation should they give in a fixed salary vs bonuses? Should they give stocks or stock options? And what about gifts, or words of praise?

With all of these options for compensation, it is clear that there is a lot to be gained by better understanding the relationship between compensation amount and type, motivation and productivity. In 2013, companies will be drawing on microeconomics to get the right balance of reward and motivation. But they will have to saw two demons first: too much trust in their own intuition or overconfidence, and lawyers.

One of the most basic findings in social science is that we are all overconfident. Most of us think that we will live longer, won’t get divorced and are less likely to crash our car. The same overconfidence permeates companies and their compensation plans. Without testing it, having it on intuition and not on science, and without seeking to improve it over time. Companies will move away from the intuition of their boards and HR departments and start to use data to understand pay more. And in doing so they will realise that their system is faulty.

Human-resource laws are complex and demanding, and they make it very difficult to pay some people in one way and other people in others. Comparing the outcomes is also very difficult. But A/B testing yields significant results in other fields, so why not for pay? Lawyers working for a company have a lot to lose in terms of blame if they approve something that turns out badly, and they have nothing to gain from potential improvements to compensation plans.

In this sense, the behaviour of the lawyers represents the most basic principle in behavioural economics – loss aversion: the idea that we focus on the downside to a much higher degree than on the positives. With a mix of knowledge and humility, some companies are working hard to overcome their internal barriers for experimenting with compensation. Their names are confidential but at least one large hotel chain, one electronics manufacturer and one software company will be paying people differently next year. More will follow.

Dan Ariely is James B. Duke professor of psychology and behavioural economics at Duke University, North Carolina, and author of The Honest Truth About Dishonesty (HarperCollins).