

INCENTIVES



THE OBJECTIVES OF THIS CHAPTER ARE TO:

- 1 SET OUT THE MAJOR CHOICES FACED BY EMPLOYERS CONTEMPLATING SETTING UP OR REVIEWING INCENTIVE PAYMENT SCHEMES
- 2 EXPLORE THE QUESTION OF HOW MANY PEOPLE ARE PAID DIFFERENT TYPES OF INCENTIVE IN THE UK
- 3 OUTLINE THE MAIN FORMS OF PAYMENT BY RESULTS (PBR) SCHEMES AND DISCUSS THEIR ADVANTAGES AND DISADVANTAGES
- 4 DEBATE THE MERITS OF INDIVIDUAL PERFORMANCE-RELATED PAY (PRP)
- 5 INTRODUCE SKILLS-BASED PAY AND DISCUSS ITS MAJOR ADVANTAGES AND DISADVANTAGES
- 6 OUTLINE THE MAJOR FORMS OF PROFIT-SHARING SCHEMES THAT OPERATE, INCLUDING THOSE SPONSORED BY THE GOVERNMENT

Incentive payments remain one of the ideas that fascinate managers as they search for the magic formula. Somewhere there is a method of linking payment to performance so effectively that their movements will coincide, enabling the manager to leave the workers on automatic pilot, as it were, while attending to more important matters such as strategic planning or going to lunch. This conviction has sustained a continuing search for this elusive formula, which has been hunted with all the fervour of those trying to find the Holy Grail or the crock of gold at the end of the rainbow.

In recent years incentives of all kinds have been the source of much debate among HR professionals, consultants, trade unionists and academic writers. While particular attention has been given to the pros and cons of individual performance-related reward systems, much has also been written in support of and against the use of team-based incentives and those which reward the acquisition of defined skills. Profit sharing and employee share ownership have been the subject of significant government initiatives and have thus also become topics about which a great deal is written.

BASIC CHOICES

While incentive payment systems are common in the UK, there are millions of employees who do not receive this kind of reward and many employers who use them only in a limited way (often in the remuneration of senior managers). It is thus perfectly possible, and some would argue desirable, to recruit, retain and motivate a workforce by paying a simple, fixed rate of pay for each job in the organisation. There is other equipment in the HR manager's toolkit which can be used to reward effort and maintain good levels of job satisfaction. The most fundamental question is therefore whether or not to use an incentive payment system at all. In the opinion of Sisson and Storey (2000, pp. 123–4) many organisations in the UK have introduced schemes in recent years for 'ideological reasons' as a means of impressing stockmarket analysts, reinforcing management control or undermining established collective bargaining machinery. These, they suggest, are poor reasons which have generally met with little long-term success. Incentive schemes should only be used where they are appropriate to the needs of the business and where they can clearly contribute to the achievement of organisational objectives.

There is a long tradition in the academic literature of hostility to incentive schemes in general and those which focus on the individual in particular. In 1966, Frederick Herzberg argued that pay was a 'hygiene factor' rather than a 'motivator'. He claimed that its capacity to motivate positively was limited, while it can very easily demotivate when managed poorly. It follows that there is little to be gained and a great deal to lose from the introduction of incentive schemes. Others (for example, Thompson 2000) have focused on the way that incentives are perceived by employees as tools of management control which reduce their autonomy and discretion. This, it is argued, causes resentment and leads to dissatisfaction and industrial conflict.

A different school of thought argues in favour of incentives on the grounds that they reward effort and behaviours which the organisation wishes to encourage. As a result they not only are a fair basis for rewarding people, but also can enhance organisational effectiveness and productivity. Advocates of **expectancy theory** hold this position with their belief that individual employees will alter their behaviour (e.g. by working harder or prioritising their actions differently) if they believe that in so doing they will be rewarded with something they value. Hence, where additional

pay is a valued reward, employees will seek it and will work to secure it. A positive outcome for both employer and employee is achievable provided the incentive is paid in return for a form of employee behaviour which genuinely contributes to the achievement of organisational objectives.

The research evidence points both ways on the question of how far incentives actually lead to performance improvements at the organisational level. Some studies suggest a correlation between superior performance and some types of incentive scheme (e.g. Huselid 1995), while others (e.g. Thompson 1992) have found no evidence of any link. Much seems to depend on the circumstances. Incentives are not universally applicable, but can play a role in enhancing individual effort or performance where the conditions and scheme design are right. Problems occur when the wrong system is imposed, on the wrong people, in the wrong circumstances or for the wrong reasons.

Where an incentive scheme is used, the next choice relates to the way the scheme is to operate. There are two basic approaches that can be used: bonus payments and incremental progression. In the case of the former, the employee is rewarded with a single payment (possibly made in stages) at the end of a payment period. In the case of profit sharing it will often be an annual payment, while sales commission is usually paid monthly. Whatever the timing, the key principle is that the pay is variable. Good performance in one period is rewarded, but the same individual could earn rather less in the next if their performance deteriorates. Some writers refer to such systems as putting 'pay at risk', because earnings vary from period to period depending on how much incentive is earned. The alternative approach involves making incremental progression dependent on the individual's contribution. The reward takes the form of a general pay rise over and above any cost of living increment being paid in a particular year. The incentive payment thus becomes consolidated into overall earnings and is not variable or 'at risk' after it has been earned.

ACTIVITY 28.1

What in your view are the main advantages and disadvantages of these alternative approaches from a management perspective? Would you be more motivated by the prospect of a pay rise or a one-off bonus payment?

Another basic choice concerns the extent of the incentive. In practice this is a decision of rather greater importance than the type of incentive scheme to be used, although it is given rather less coverage in the literature. There is the world of difference, in terms of cost and employee perception, between a scheme which rewards people with 3 per cent or 4 per cent of salary and one which pays a sum equivalent to 25 per cent. Studies undertaken in the USA, reported by Bartol and Durham (2000, p. 14), suggest that the minimum level of bonus or pay rise 'necessary to elicit positive perceptual and attitudinal responses' is between 5 per cent and 7 per cent of salary. Lesser payments are thus unlikely to provide meaningful incentives and will have only a peripheral impact. According to Hendry *et al.* (2000, p. 54) this has been a major problem for schemes introduced in the public sector where incentives have



tended to be worth a maximum of only 2 per cent or 3 per cent of salary. Armstrong and Murlis (1998) offer the following advice:

As a rule of thumb, those whose performance is outstanding may deserve and expect rewards of 10% and more in their earlier period in a job. People whose level of performance and rate of development is well above the average may merit increases of between 7 and 9%, while those who are progressing well at the expected rate towards the fully competent level may warrant an increase of between 4% and 6%. Increases of between 0% and 3% may be justified for those who are not making such good progress but who are still developing steadily. Performance-related increases of less than 2–3% are hardly worth giving. Much also depends on current market movement and this affects expectations. (Armstrong and Murlis 1998, pp. 286–9)

The final choice concerns the level at which the incentive will be paid. Some schemes reward individuals for individual performance, others reward a group of employees or team for their collective performance. Finally there are schemes which share incentive payments out among all employees in the organisation or within individual business units. These are not mutually exclusive. It is possible, for example, to reward a salesperson with three types of incentive, one from each level. The basic pay would thus be enhanced with commission calculated individually, with a performance-based payment made to all in his/her sales team to reflect excellent customer feedback, and finally with a profit-related bonus paid to all employees in the organisation. Team-based incentives have tended to get a better press in recent years than individual incentives, a major problem with the latter being their tendency to undermine teamworking in situations where it is an important contributor to competitive advantage (*see* Pfeffer 1998, pp. 218–20).

WINDOW ON PRACTICE

Peter and Patrick are sales consultants for a financial services company and both had business targets for a six-month period. Peter met his target comfortably and received the predetermined bonus of £6,000 for reaching on-target earnings. Patrick failed to reach his target because his sales manager boss left the company and poached two of Patrick's prime customers just before they signed agreements with Patrick, whose bonus was therefore £2,000 instead of £6,250.

Joanne was a sales consultant for the same company as Peter and Patrick. Before the sales manager left, he made over to her several promising clients with whom he had done considerable preparatory work and who were not willing to be 'poached' by his new employer. All of these signed agreements and one of them decided to increase the value of the deal tenfold without any reference to Joanne until after that decision was made, and without knowing that she was now the appropriate contact. Her bonus for the period was £23,400.

Henry is a production manager in a light engineering company with performance pay related to a formula combining output with value added. Bonus payments were made monthly in anticipation of what they should be. One of Henry's initiatives was to increase the gearing of the payment by results scheme in the factory. Through peculiarities of company accounting his bonus payments were 'justified' according to the formula, but later it was calculated that the production costs had risen by an amount that cancelled out the value-added benefits. Also 30 per cent of the year's output had to be recalled due to a design fault.

Patrick had his bonus made up to £6,250. Joanne had her bonus reduced to £8,000, but took legal advice and had the amount cut restored, whereupon Peter and Patrick both threatened to resign until mollified by *ex gratia* payments of £2,000 each. Peter resigned three months later. Henry was dismissed.

THE EXTENT TO WHICH INCENTIVES ARE PAID

There is conflicting evidence about how widespread incentive payments are in the UK and about whether or not they are becoming more or less common. Each year the government's New Earnings Survey selects a sample of over 100,000 employees from across the country and asks their employers to fill in a form outlining their earnings in the previous tax year. One of the questions asks about incentive payments 'such as piecework, commission, profit sharing, productivity and other incentives/bonuses'. In 2003 (ONS 2003) the survey results revealed that only 14 per cent of employees were receiving such payments, but no occupational breakdown was provided. However, previous editions of the survey have shown that the proportion of manual workers being paid through incentive schemes (around 25 per cent) is considerably higher than is the case for non-manual workers (10 per cent), suggesting that the most common use of incentives involves the use of traditional piecework or payment by results schemes in the manufacturing and agricultural sectors. Other approaches, such as individual performance-related pay, appear restricted to relatively small numbers of employees.

However, other surveys paint a rather different picture. The authors analysing the 1998 Workplace Employment Relations Survey (Millward *et al.* 2000, pp. 212–13) concluded that around 60 per cent of the 2,191 workplaces in their sample operated either a payment by results or a merit pay incentive scheme. They concluded that, on balance, the proportion was similar to that reported in the 1990 survey, indicating no overall change in the extent of incentive schemes. In 1998 an IPD survey of 1,158 organisations found that 40 per cent of the respondents operated a merit pay system and that the median percentage of employees covered by the schemes was between 70 and 80 per cent. This survey (IPD 1998) also produced evidence of growth, a majority of the schemes in operation having been started within the previous five years. More recent published data (*see* Thompson and Milsome 2001 and CIPD 2004) tells the same story, a majority of respondents stating that they operate a variable payment scheme of some kind. Other smaller surveys such as those described by Brown and Armstrong (2000, pp. 19–23) lead to a similar conclusion – namely that

incentive schemes of one kind or another are common and are steadily becoming more widespread.

It is not easy to reconcile the diverse results produced by these surveys. One possibility is that the different results may reflect the different samples used. The New Earnings Survey covers workplaces of all sizes, including the very smallest, while the others tend to focus on larger employers. It could therefore be the case that incentive schemes are largely used in bigger firms with more sophisticated management practices. Another possibility is that a high proportion of the schemes in operation reward employees with performance-based incremental payments (that is, a pay rise) rather than a one-off annual bonus. These might well not be picked up by the New Earnings Survey, which asks specifically about the amount of incentive payment received in the previous tax year. A further possibility is that many of the schemes in operation only apply to senior managers and not to the generality of staff.

ACTIVITY 28.2

What other factors might account for the different results picked up by these surveys? How could a survey be designed which would give definitive information about the extent of incentive payments in the UK?



It is thus difficult to reach a firm conclusion. It would appear that a majority of larger employers operate some form of incentive scheme, but that the majority of the UK workforce are not covered. There has been some growth in recent years (*see* IRS 2003, pp. 31–3), but this is patchy and cannot conceal the fact that many schemes are withdrawn as well as established each year. Team-based incentive schemes and skills-based approaches, such as those based on individual performance, are also growing in number but are operated only by a small proportion of employers.

PAYMENT BY RESULTS SCHEMES

Historically, the most widely used incentive schemes have been those which reward employees according to the number of items or units of work they produce or the time they take to produce them. This approach is associated with F.W. Taylor and the phase in the development of personnel management described in Chapter 1 under the heading ‘Humane bureaucracy’. Little attention has been paid to the operation of piecework schemes in recent years and there is clear evidence to show that they are in decline, both in terms of the proportion of total pay which is determined according to PBR principles and in terms of the number of employees paid in this way. The results of the annual New Earnings Surveys, however, show that PBR is still widely used, in some shape or form, by employers of manual workers.

Individual time saving

It is rare for a scheme to be based on the purest form of piecework, a payment of X pence per piece produced, as this provides no security against external influences

which depress output such as machine failure or delays in the delivery of raw materials. The most common type of scheme in use, therefore, is one where the incentive is paid for time saved in performing a specified operation. A standard time is derived for a work sequence and the employee receives an additional payment for the time saved in completing a number of such operations. If it is not possible to work due to shortage of materials or some other reason, the time involved is not counted when the sums are done at the end of the day.

Standard times are derived by the twin techniques of method study and work measurement, which are the skills of the work study engineer. By study of the operation, the work study engineer decides what is the most efficient way to carry it out and then times an operator actually doing the job over a period, so as to measure the 'standard time'. Work-measured schemes of this kind have, however, been subject to a great deal of criticism and are only effective where people are employed on short-cycle manual operations with the volume of output varying between individuals depending on their skill or application.

The main difficulty, from the employee's point of view, is the fluctuation in earnings that occurs as a consequence of a varying level of demand for the product. If the fluctuations are considerable then the employees will be encouraged to try to stabilise them, either by pressing for the guaranteed element to be increased, or by storing output in the good times to prevent the worst effects of the bad, or by social control of high-performing individuals to share out the benefits of the scheme as equally as possible.

Measured daywork

To some people the idea of measured daywork provides the answer to the shortcomings of individual incentive schemes. Instead of employees receiving a variable payment in accordance with the output achieved, they are paid a fixed sum as long as they maintain a predetermined and agreed level of working. Employees thus have far less discretion over the amount of effort they expend. Theoretically, this deals with the key problem of other schemes by providing for both stable earnings and stable output instead of 'as much as you can, if you can'.

The advantage of measured daywork over time-saving schemes, from the management point of view, is the greater level of management control that is exercised. The principal disadvantage is the tendency for the agreed level of working to become a readily achievable norm which can only be increased after negotiation with work-force representatives.

Group and plant-wide incentives

Sometimes the principles of individual time saving are applied to group rather than individual output to improve group performance and to promote the development of teamworking. Where jobs are interdependent, group incentives can be appropriate, but it may also put great pressure on the group members, aggravating any interpersonal animosity that exists and increasing the likelihood of stoppages for industrial action. Group schemes can also severely reduce the level of management control by allowing the production group to determine output according to the financial needs of individual group members.

A variant on the group incentive is the plant-wide bonus scheme, under which all employees in a plant or other organisation share in a pool bonus that is linked to the level of output, the value added by the employees collectively or some similar formula. The attraction of these methods lies in the fact that the benefit to the management of the organisation is 'real' because the measurement is made at the end of the system, compared with the measurements most usually made at different points within the system, whereby wages and labour costs can go up while output and profitability both come down. Theoretically, employees are also more likely to identify with the organisation as a whole, they will cooperate more readily with the management and each other, and there is even an element of workers' control. The difficulties lie in the fact that there is no tangible link between individual effort and individual reward, so that those who are working effectively can have their efforts nullified by others working less effectively or by misfortunes elsewhere.

Commission

The payment of commission on sales is a widespread practice about which surprisingly little is known as these schemes have not come under the same close scrutiny as incentive schemes for manual employees. They suffer from most of the same drawbacks as manual incentives, except that they are linked to business won rather than to output achieved.

ACTIVITY 28.3

A problem with sales commission is its tendency to reward the quantity of goods sold without having regard to the quality of service provided by sales staff. In which circumstances might this have negative consequences? How could a commission-based incentive scheme be adapted to incorporate measures of quality as well as quantity?



DISADVANTAGES OF PBR SCHEMES

The whole concept of payment by results was set up to cope with a stable and predictable situation, within the boundaries of the workplace. External demands from customers were irritations for others – such as sales representatives – to worry about. The factory was the arena, the juxtaposed parties were the management on the one hand and the people doing the work on the other, and the deal was output in exchange for cash. The dramatic changes of the past twenty years, which have swept away stability, dismantled the organisational boundary and enthroned the customer as arbiter of almost everything have also made PBR almost obsolete.

According to the New Earnings Survey the proportion of manual workers receiving PBR payments has been in steady decline since 1983. This trend can be explained, in part, by changing technologies and changes in working practices. A payment system that puts the greatest emphasis on the number of items produced or on the

time taken to produce them is inappropriate in industries where product quality is of greater significance than product quantity. Similarly a manufacturing company operating a just-in-time system will rely too heavily on overall plant performance to benefit from a payment scheme that primarily rewards individual effort.

In addition to the problem of fluctuating earnings, described above, there are a number of further inherent disadvantages which explain the decline of PBR-based remuneration arrangements.

Operational inefficiencies

For incentives to work to the mutual satisfaction of both parties, there has to be a smooth operational flow, with materials, job cards, equipment and storage space all readily available exactly when they are needed, and an insatiable demand for the output. Seldom can these conditions be guaranteed and when they do exist they seldom last without snags. Raw materials run out, job cards are not available, tools are faulty, the stores are full, customer demand is fluctuating or there is trouble with the computer. As soon as this sort of thing happens the incentive-paid worker has an incentive either to fiddle the scheme or to negotiate its alteration for protection against operational vagaries.

Quality of work

The stimulus to increase volume of output can adversely affect the quality of output, as there is an incentive to do things as quickly as possible. If the payment scheme is organised so that only output meeting quality standards is paid for, there may still be the tendency to produce expensive scrap. Operatives filling jars with marmalade may break the jars if they work too hurriedly. This means that the jar is lost and the marmalade as well, for fear of glass splinters.

Renewed emphasis on quality and customer satisfaction mean that employers increasingly need to reward individuals with the most highly developed skills or those who are most readily adaptable to the operation of new methods and technologies. PBR, with its emphasis on the quantity of items produced or sold, may be judged inappropriate for organisations competing in markets in which the quality of production is of greater significance than previously.

The quality of working life

There is also a danger that PBR schemes may demotivate the workforce and so impair the quality of working life for individual employees. In our industrial consciousness PBR is associated with the worst aspects of rationalised work: routine, tight control, hyper-specialisation and mechanistic practices. The worker is characterised as an adjunct to the machine, or as an alternative to a machine. Although this may not necessarily be the case, it is usually so, and generally expected. Payment by results in this way reinforces the mechanical element in the control of working relationships by failing to reward employee initiative, skills acquisition or flexibility. There is also evidence to suggest that achieving high levels of productivity by requiring individuals to undertake the same repetitive tasks again and again during the working day increases stress levels and can make some employees susceptible to repetitive strain injuries.

The selective nature of the incentive

Seldom do incentive arrangements cover all employees. Typically, groups of employees are working on a payment basis which permits their earnings to be geared to their output, while their performance depends on the before or after processes of employees not so rewarded, such as craftsmen making tools and fixtures, labourers bringing materials in and out, fork-lift truck drivers, storekeepers and so forth.

The conventional way round the problem is to pay the ‘others’ a bonus linked to the incentive earned by those receiving it. The reasoning for this is that those who expect to earn more (such as the craftspeople) have a favourable differential guaranteed as well as an interest in high levels of output, while that same interest in sustaining output is generated in the other employees (such as the labourers and the storekeepers) without whom the incentive earners cannot maintain their output levels. The drawbacks are obvious. The labour costs are increased by making additional payments to employees on a non-discriminating basis, so that the storekeeper who is a hindrance to output will still derive benefit from the efforts of others, and the employees whose efforts are directly rewarded by incentives feel that the fruits of their labour are being shared by those whose labours are not so directly controlled.

Obscurity of payment arrangements

Because of these difficulties, incentive schemes are constantly modified or refined in an attempt to circumvent fiddling or to get a fresh stimulus to output, or in response to employee demands for some other type of change. This leads to a situation in which the employees find it hard to understand what behaviour by them leads to particular results in payment terms. This same obscurity is often found in the latest fashion in PRP. In a recent unpublished study comparing performance management in two blue-chip companies, less than half the people in management posts claimed to understand how the payments were calculated. Many of those actually misunderstood their schemes!

PERFORMANCE-RELATED PAY

Arguments about the advantages and disadvantages of individual PRP have been some of the most hotly contested in recent decades. The topic has formed the basis of numerous research studies and remains one which attracts much controversy, as was shown in recent debates about the introduction of PRP for teachers working in state schools. The main reason is the apparent contrast between the theoretical attractiveness of such systems – at least from a management perspective – and their supposed tendency to disappoint when operated in practice. While there are many different types of scheme available, all involve the award of a pay rise or bonus payment to individual employees following a formal assessment of their performance over a defined period (normally the previous year). Two distinct varieties of scheme can be identified.

Merit-based systems simply involve the immediate supervisor undertaking an appraisal of each subordinate’s work performance during the previous year. This will typically be done following a formal appraisal interview and often requires the completion of standard documentation drawn up by an HR department. A proportion of future remuneration is then linked to a score derived from the supervisor’s

assessment. Some systems require supervisors to award a percentage mark against different criteria, while others oblige them to assess individual performance as 'excellent', 'good', 'satisfactory' or 'inadequate'. Merit-based systems are generally regarded as unsatisfactory because they allow considerable scope for assessors to make subjective judgements or to allow personal prejudice to colour their assessments. There is also a tendency to give undue weight to recent events at the expense of achievements taking place early in the appraisal period.

Goal-based systems are more objective, but are not appropriate for all kinds of job. They are, however, particularly well suited for the assessment of managerial work. Here the supervisor and subordinate meet at the start of the appraisal period and agree between them a list of objectives which the appraisee will seek to meet during the coming months. Examples would be the completion of particular projects, the establishment of new initiatives, undertaking a course of training or making substantial progress towards the solving of a problem. Many employers nowadays seek to link individual objectives directly to defined organisational goals for the year as a means of reinforcing their significance and ensuring that all are pulling in the same direction. At the end of the year the employee is assessed on the basis of which objectives have or have not been met. A score is then derived and a bonus payment or pay rise awarded. Where performance in a job can meaningfully be assessed in this way, such systems are recommended because they are reasonably objective and straightforward to score. Where the nature of the job involves the consistent achievement of a defined level of performance, and cannot usefully be assessed in terms of the achievement of specific objectives, the goal-based approach has less to offer. It may still be possible to assess part of the job in this way, but there will also have to be a merit-based element if the appraisal is to reflect all of a person's activity during the appraisal period.

ACTIVITY 28.4

Make a list of five jobs that you consider would be best rewarded by a merit-based system and five more that are best rewarded via the goal-based approach.

The attractions of PRP

It is not difficult to see why PRP has attracted the interest of managers, consultants and government ministers. Its theoretical attractions are considerable and include the following:

- attracting and retaining good performers;
- improving individual and corporate performance;
- clarifying job roles and duties;
- improving communication;
- improving motivation;
- reinforcing management control;
- identifying developmental objectives;

- reinforcing the individual employment relationship at the expense of the collective;
- rewarding individuals without needing to promote them.

In short PRP aims to provide a flexible and cost-effective means of distributing rewards fairly between the good and poorer performers while also contributing towards improved organisation performance. Moreover, it is based on principles to which most people, employees as well as managers, seem to adhere (Brown and Armstrong 2000, pp. 11–13). Most of us are very happy to see individuals rewarded for superior performance and/or effort and would like payment decisions to be based on such criteria. The problems arise when attempts are made to put the principles into practice. A system which is fair and objective in theory can easily fail to achieve these objectives when implemented.

Critiques of PRP

Performance-related pay attracted a great amount of criticism from academic researchers in the 1980s and 1990s during a period when its virtues were frequently asserted by HR managers and consultants. The attacks came from several quarters. Occupational psychologists tended to question the ability of PRP to motivate positively (e.g. Kohn 1993), while sociologists saw it as a means of reinforcing management control at the expense of worker autonomy (e.g. Hendry *et al.* 2000). A further source of criticism has come from those who suspect that PRP is used as a means of perpetuating gender inequality in payment matters (e.g. Rubery 1985). However, the most colourful and damning criticisms have come from management thinkers such as W. Edwards Deming who advocate Total Quality Management approaches (*see* Chapter 11) and for whom PRP represents exactly the wrong kind of initiative to introduce. The whole basis of their philosophy is the substitution of ‘leadership’ for ‘supervision’, removing organisational hierarchies and managing people with as little direction and control as possible. They see PRP as having the opposite effect. It reinforces the hierarchy, enhances the power of supervisors and strengthens management control.

For many critics, including those cited above, PRP has fundamental flaws which cannot be overcome. Kohn, for example, argues that incentives can only succeed in securing temporary compliance. Their use cannot change underlying attitudes, while the attempt to do so ultimately damages the long-term health of an organisation by undermining relationships and encouraging employees to focus on short-term aims:

Managers who insist that the job won't get done right without rewards have failed to offer a convincing argument for behavioural manipulation. Promising a reward to someone who appears unmotivated is a bit like offering salt water to someone who is thirsty. Bribes in the workplace simply can't work. (Kohn 1993, p. 60)

A second stream of criticism is more moderate, arguing that PRP can have a role to play in organisations, but that its positive effects are limited. Moreover, while not fundamentally flawed, PRP is very difficult to implement effectively in practice. As a result, systems fail as often as they succeed. The arguments are summarised well by Gomez-Mejia and Balkin (1992, pp. 249–55), Cannell and Wood (1992,

pp. 66–101), Pfeffer (1998, pp. 203–4) and Purcell (2000). The major points made by these authors are as follows:

- 1 Employees paid by PRP, especially where the incentive is substantial, tend to develop a narrow focus to their work. They concentrate on those aspects which they believe will initiate payments, while neglecting other parts of their jobs.
- 2 PRP, because of its individual nature, tends to undermine teamworking. People focus on their own objectives at the expense of cooperation with colleagues.
- 3 PRP, because it involves managers rating employees, can lead to a situation in which a majority of staff are demotivated when they receive their rating. This occurs where people perceive their own performance to be rather better than it is considered to be by their supervisors – a common situation. The result is a negative effect on the motivation of the staff who are unexceptional, but loyal and valued. These are often the very people on whom organisations depend most.
- 4 Employees are rarely in a position wholly to determine the outcomes of their own performance. Factors outside their control play an important role, leading to a situation in which the achievement or non-achievement of objectives is partially a matter of chance.
- 5 Even the most experienced managers find it difficult to undertake fair and objective appraisals of their employees' performance. Subjective judgements are often taken into account leading to perceptions of bias. Some managers deliberately manipulate ratings for political reasons, allowing their judgement to be coloured by the effect they perceive the outcome will have on particular employees. Low ratings are thus avoided, as are very high ratings, where it is perceived this will lead to disharmony or deterioration of personal relationships.
- 6 In organisations subject to swift and profound change, objectives set for the coming year may become obsolete after a few months. Employees then find themselves with an incentive to meet goals which are no longer priorities for the organisation.
- 7 PRP systems tend to discourage creative thinking, the challenging of established ways of doing things and a questioning attitude among employees.
- 8 Budgetary constraints often lead managers to reduce ratings, creating a situation in which excellent individual performance is not properly rewarded.
- 9 It is difficult to ensure that each line manager takes a uniform approach to the rating of their subordinates. Some tend to be more generously disposed in general than others, leading to inconsistency and perceptions of unfairness.
- 10 When the results of performance appraisal meetings have an impact on pay levels, employees tend to downplay their weaknesses. As a result development needs are not discussed or addressed.
- 11 PRP systems invariably increase the paybill. This occurs because managers fear demotivating their staff by awarding low or zero rises in the first years of a system's operation. Poorer performers are thus rewarded as well as better performers.

Using PRP effectively

Despite the problems described above it is possible to implement PRP successfully, as is shown by the experience of case study companies quoted by Brown and

Armstrong (2000), IRS (2000) and IDS (2003). It will only work, however, if it is used in appropriate circumstances and if it is implemented properly. Part of the problem with PRP has been a tendency in the HR press to portray it as universally applicable and as a panacea capable of improving performance dramatically. In fact it is neither, but is one of a range of tools that have a useful if limited role to play in some situations. Gomez-Mejia and Balkin (1992) specify the following favourable conditions:

- 1 Where individual performance can be objectively and meaningfully measured.
- 2 Where individuals are in a position to control the outcomes of their work.
- 3 Where close team working or cooperation with others is not central to successful job performance.
- 4 Where there is an individualistic organisational culture.

In addition, Brown and Armstrong (2000) rightly point to the importance of careful implementation and lengthy preparation prior to the installation of a scheme. Moreover, they argue that PRP should not be looked at or judged in isolation from other forms of reward, both extrinsic and intrinsic. Success or failure can hinge on what else is being done to maximise motivation, to develop people and to improve their job security.

Ultimately PRP has one great advantage which no amount of criticism can remove: it helps ensure that organisational priorities become individual priorities. Managers can signal the importance of a particular objective by including it in a subordinate's goals for the coming year. If the possibility of additional payment is then tied to its achievement, the chances that the objective concerned will be met increases significantly. Organisational performance is improved as a result. Where the achievement of such specific objectives forms a relatively minor part of someone's job, PRP can form a relatively minor part of their pay packet. Other rewards can then be used to recognise other kinds of achievement.

WINDOW ON PRACTICE

Many job descriptions for supervisory positions include reference to responsibility for ensuring that the appropriate health and safety at work regulations are adhered to. Few supervisors, however, left to themselves would see this aspect of their work as a priority. In one organisation known to the authors it was decided to try to raise the profile of health and safety issues by including objectives in this field into managers' annual performance targets. It therefore became clear that the level of PRP in the following year would, in part, be determined by the extent to which the health and safety objectives had been met.

The result was the swift establishment of departmental health and safety committees and schemes whereby staff could bring safety hazards to the attention of supervisors.

SKILLS-BASED PAY

A further kind of incentive payment scheme is one which seeks to reward employees for the skills or competencies which they acquire. It is well established in the United States and, according to IRS (2003), is becoming a good deal more common among British employers. It is particularly prevalent as a means of rewarding technical staff, but there is no reason why the principle should not be extended to any group of employees for whom the acquisition of additional skills might benefit the organisation.

There are several potential benefits for an employer introducing a skills-based pay scheme. Its most obvious effect is to encourage multiskilling and flexibility enabling the organisation to respond more effectively and speedily to the needs of customers. A multiskilled workforce may also be slimmer and less expensive. In addition it is argued that, in rewarding skills acquisition, a company will attract and retain staff more effectively than its competitors in the labour market. The operation of a skills-based reward system is proof that the sponsoring employer is genuinely committed to employee development.

Most skills-based payment systems reward employees with additional increments to their base pay once they have completed defined skill modules. A number of such schemes are described in detail in a study published by Incomes Data Services (1992). Typical is the scheme operated by Venture Pressings Ltd where staff are employed on four basic grades, each divided into 10 increments. Employees progress up the scale by acquiring specific skills and demonstrating proficiency in them to the satisfaction of internal assessors. New starters are also assessed and begin their employment on the incremental point most appropriate to the level of skills they can demonstrate. In many industries it is now possible to link payment for skills acquisition directly to the attainment of National Vocational Qualifications (NVQs) for which both the setting of standards and the assessment of individual competence are carried out externally.

A skills-based pay system will only be cost effective if it results in productivity increases which are sufficient to cover the considerable costs associated with its introduction and maintenance. A business can invest a great deal of resources both in training its workforce to attain new skills, and in rewarding them once those skills have been acquired, only to find that the cost of the scheme outweighs the benefit gained in terms of increased flexibility and efficiency. Furthermore, in assisting employees to become more highly qualified and in many cases to gain NVQs, an employer may actually find it harder to retain its staff in relatively competitive labour markets.

The other major potential disadvantage is associated with skills obsolescence. Where a business operates in a fast-moving environment and needs to adapt its technology regularly, a skills-based payment system can leave the organisation paying enhanced salaries for skills which are no longer significant or are not required at all. Employers seeking to introduce skills-based systems of payment therefore need to consider the implications very carefully and must ensure that they only reward the acquisition of those skills which will clearly contribute to increased productivity over the long term.

ACTIVITY 28.5

A number of commentators praise skills-based pay as a system which avoids some of the pitfalls associated with PRP schemes. Look back at the list of practical problems with PRP schemes above and consider which do and which do not apply to skills-based incentive systems.



PROFIT SHARING

There are a number of different ways in which companies are able to link remuneration to profit levels. In recent years the government has sought to encourage such schemes and has actively promoted their establishment with advantageous tax arrangements. Underlying government support is the belief that linking pay to profits increases the employee's commitment to his or her company by deepening the level of mutual interest. As a result, it is argued that such schemes act as an incentive encouraging employees to work harder and with greater flexibility in pursuit of higher levels of take-home pay. Other potential advantages for employers described by Pendleton (2000, pp. 346–51) are better cost flexibility, changed attitudes on the part of employees and the discouragement of union membership.

Cash-based schemes

The traditional and most common profit-sharing arrangement is simply to pay employees a cash bonus, calculated as a proportion of annual profits, on which the employee incurs both a PAYE and a national insurance liability. Some organisations pay discretionary profit bonuses on this basis, while others allocate a fixed proportion of profits to employees as a matter of policy. **Gainsharing** is a variation on cash-based profit sharing which is widely used in the USA and which can be used in non-profit-making organisations as well as those operating in the commercial sector. Here the bonus relates to costs saved rather than profit generated in a defined period. So if a workforce successfully achieves the same level of output at lower overall cost, the gain is shared between employer and employees.

Between 1987 and 2000 the government operated an approved profit-related pay scheme which became increasingly popular. By 1996 there were over 14,000 schemes in operation, covering 3.7 million employees. The attraction was the ability profit-related pay schemes gave employers to give pay rises to all employees, while recouping the cost through tax concessions. The scheme was phased out and has now been replaced by the Share Incentive Plan (*see below*).

Share-based schemes

There are several methods of profit sharing which involve employees being awarded shares rather than cash. Here too there are government-sponsored schemes in operation which involve favourable tax treatment.

The Savings-Related Share Option scheme permits organisations to grant share options to directors and employees in a tax-effective manner. This means that they are given the opportunity to buy shares in their own companies at a future date, but at the current price. The hope is that the value will have increased in the meantime, allowing the purchaser to cash in a tidy profit. This particular government-sponsored scheme requires participants to put between £5 and £250 of their monthly pay aside and then to use the proceeds of the accumulated fund, after three, five or seven years, to buy shares at a discount of 20 per cent of the price they were when the plan started.

From 2001 it has also been possible for employers to set up Inland Revenue approved Share Incentive Plans (previously called All-Employee Share Schemes) that allow employees to obtain shares in their own companies while avoiding tax and national insurance contributions. Employers can give such shares to employees to a maximum value of £3,000 per year. Some can be given in recognition of individual or team performance, making it possible to award some employees more shares than others. Where employees subsequently hold these shares for three years or more, there is no tax liability when they are sold. In addition, under the scheme, employees can buy up to a further £1,500 worth of shares out of pre-tax income and subsequently avoid a proportion of the tax owed when they are sold. Companies are also allowed to give 'free' matching shares for each share purchased by an employee under the scheme. Employers as well as employees gain tax advantages from operating these schemes. Deductions in corporation tax can be made equivalent to the amount of salary used by employees to purchase shares, as well as monies used in establishing and operating the scheme.

Disadvantages of profit-related schemes

The obvious disadvantage of the schemes described above from the employee's point of view is the risk that pay levels may decline if the company fails to meet its expected profit levels. If no profit is made it cannot be shared. Share values can go down as well as up. Companies are not permitted to make guarantees about meeting payments and will have their schemes revoked by the Inland Revenue if they do so. In any event it is likely that profit-based incentives will vary in magnitude from year to year.

For these reasons it is questionable to assert that profit-sharing schemes do in fact act as incentives. Unlike PRP awards they do not relate specifically to the actions of the individual employee. Annual profit levels are clearly influenced by a whole range of factors which are both internal and external to the company. An employee may well develop a community of interest with the company management, shareholders and other employees but it is unlikely seriously to affect the nature of his or her work. Furthermore, both poor and good performers are rewarded equally in profit-related schemes. The incentive effect will therefore be very slight in most cases and will be restricted to a general increase in employee commitment.

SUMMARY PROPOSITIONS

- 28.1** Incentive schemes should be used where they are appropriate to the needs of the business and where they can clearly contribute to the achievement of organisational objectives.
- 28.2** Incentive payment schemes either involve the payment of a bonus or form the basis of incremental progression systems. In either case, the reward should represent at least 7 per cent of salary if there is to be a meaningful incentive effect.
- 28.3** The extent to which different types of incentive arrangement are used in the UK is unclear. There is evidence of growth in recent years, but the majority of employees are not covered by such schemes.
- 28.4** Methods of payment by results include individual time saving, group incentives, measured daywork, plant-wide schemes, productivity schemes and commission.
- 28.5** Performance-related pay systems are either merit based or goal based. They have been the subject of notable debate in recent years, many researchers finding a mismatch between their theoretical attractions and practical outcomes.
- 28.6** Skills-based pay involves linking incentives to the achievement of defined competencies or qualifications. It rewards what people bring to the job rather than the results of their efforts.
- 28.7** Profit sharing has been promoted by governments for many years. The Share Incentive Plan is the latest attempt to encourage employees to hold shares in their own companies.

GENERAL DISCUSSION TOPICS

- 1 What are the relative advantages of: (a) a system of straight salary that is the same each month, and (b) a system of salary with an individual performance-related addition so that the total payment each month varies?
- 2 In what circumstances might it be appropriate to base individual payment on team performance?
- 3 What do you think about Peter, Patrick, Joanne and Henry in the Window on practice box early in this chapter?

FURTHER READING

Brown, D. and Armstrong, M. (2000) *Paying or Contribution: real performance-related pay strategies*. London: Kogan Page

Kohn, A. (1993) 'Why Incentive Plans Cannot Work', *Harvard Business Review*, September–October, pp. 54–63

The debate about the merits of individual performance-related pay is so polarised that it is rare to find a balanced account that sets out the views of those who are for and those who are against. It is best to read the partisan accounts. Kohn's (1993) article contains an eloquent and

damning critique of such schemes, while Brown and Armstrong (2000) paint a more positive picture.

Incomes Data Services

Industrial Relations Services

Information about trends in the design of incentive payment schemes is regularly provided in the IDS and IRS publications. They also commonly feature case studies which show exactly how the various schemes operate in practice as well as regular surveys of current practice that can be used for benchmarking processes.

Thorpe, R. and Homan, G. (eds) *Strategic Reward Systems*. London: Financial Times/Prentice Hall

Several chapters in this book concern incentive payment systems of one kind or another. The book includes extensive material on PRP, skills-based pay, gainsharing, profit-sharing and team-based incentives.

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An extensive range of additional materials, including multiple choice questions, answers to questions and links to useful websites can be found on the Human Resource Management Companion Website at www.pearsoned.co.uk/torrington.

