

# **PERFORMANCE-RELATED AND SKILL-BASED PAY: AN INTRODUCTION**

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## CONTENTS

Introduction

Importance of Pay and Myths about Pay

Objectives of Pay

Pay Reform: The Move to Performance Pay

Objectives of Performance-Related Pay and Its Relationship  
to Other Rewards and Strategies

Problems and Issues

Performance Criteria Choices

Types of Schemes and Performance Pay

- \* types of schemes
- \* merit pay
- \* incentive payments
- \* group incentives and productivity gain sharing
- \* profit sharing
- \* long term incentives
- \* performance bonus
- \* flexible benefits

What is Skill-Based Pay?

Reasons for Skill-Based Pay

Advantages of Skill-Based Pay

Introducing the System

Problems in Skill-Based Pay

Factors for Success

(ii)

Appropriate Industries

Conclusions and Guidelines

Appendix A

Bibliography

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# Performance Related and Skill-Based Pay: An Introduction

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*An employee owes no loyalty, he owes no love  
and no attitudes - he owes performance and nothing else.*

Peter Drucker, Management:  
Tasks, Responsibilities, Practices (1974)

## Introduction

This Paper provides an introduction to one of the important shifts occurring in the field of remuneration, namely, the move from standard ways of remunerating employees based on criteria which have little to do with their contribution to the organization's performance, to a system which specifically seeks to reward employees for their contribution as individuals or as part of a group, or to reward employees on account of the organization's overall positive performance. In doing so, the Paper confines itself to some of the basic principles and trends which can be extracted from various experiences. It does not provide a step by step procedure for those seeking to introduce a performance based pay system. But it does highlight some of the problems involved, and provides guidelines which need to be borne in mind when seeking to introduce a pay system geared to performance and skills.

It is important to note that no particular model can be recommended. The system introduced must be conditioned by a variety of factors such as the nature of the business, its business and human resource management strategies and so on. As pointed out by E.E. Lawler (*The Other Pay: A Strategic Approach*):

The new pay argues in favour of a pay-design process that starts with business strategy and organizational design. It argues against an assumption that certain best practices must be incorporated into a company's pay approach.

Besides, performance and skill-based pay systems need to be negotiated and introduced at the enterprise level, and cannot be negotiated or designed at the macro, or even at the industry, level. It follows, therefore, that it is not possible to recommend a

particular system which could be introduced across several enterprises or across an industry. This is evident from the following steps that need to be taken before introducing such a scheme in an enterprise.

- A pay expert, or the management, would have to analyse the existing pay structure.
- The business strategies and objectives of the enterprise and its overall human resource management policies should be determined.
- It has to be ascertained whether the scheme to be introduced would fit within the overall corporate and human resource management objectives of the enterprise, as they must all fit together.
- The objectives of the system to be introduced should be clearly identified.
- The scheme should be negotiated, and employees consulted, to ascertain whether the desired objectives are likely to be achieved.
- Changes needed to be made in the workplace should be identified.
- A performance management system has to be introduced.
- Mechanisms to monitor and review the scheme should be agreed upon.

The guidelines outlined in the Paper could help to guard against possible pitfalls and to identify some of the procedures to be followed, as well as to assist in making choices between different types of schemes which may be introduced to achieve the objectives. The guidelines can also facilitate the identification of the types of schemes suitable to particular types of businesses and tasks.

### **Importance of Pay and Myths about Pay**

Pay represents the most important and contentious element in the employment relationship, and is of equal interest to the employer, employee and government -

- \* to the employer, because it can represent a significant part of his costs, is important to his employees' performance and to competitiveness, and affects his ability to recruit and retain a labour force of quality;
- \* to the employee, because it is fundamental to his standard of living and is a measure of the value of his services or performance;
- \* to the government because it affects aspects of macro-economic stability

such as employment, inflation, purchasing power and socio-economic development in general.

While the basic wage or pay is the main component of compensation, fringe benefits and cash and non-cash benefits influence the level of wages or pay because the employer is concerned more about labour costs rather than wage rates *per se*. The tendency now is towards an increasing mix of fringe benefits, which therefore exert an important impact on pay levels. In industrialized countries, and sometimes in countries with high personal tax rates, the non-salary element of executive compensation has substantially increased in recent years.

It is useful, at the outset, to remove some common misconceptions about pay (see Jeffrey Pfeffer *Six Dangerous Myths About Pay*):

- \* Labour rates and labour costs are not the same thing. The labour costs of an enterprise paying wage rates higher than its competitor are not necessarily greater if its productivity is higher. It is labour costs, rather than labour rates, which matter. The message was well delivered by the Director of Industrial Relations, Ford Motor Co. in 1986:
 

Many politicians and economists are surprised that, despite high unemployment and falling inflation, wage settlements have continued to run at a high level. That is because they do not understand that employers are interested not in wage rates, but in labour costs. Firms are willing to grant wage increases if the labour costs do not go up.
- \* Reducing or freezing wage rates, therefore, is no guarantee of control of labour costs.
- \* There is no general rule that labour costs represent a major proportion of total costs. This is so in some cases (e.g. in consultancy firms) but not in all others.
- \* Low labour costs do not build sustainable competitive advantage, and sustained productivity growth often leads to increases in real wages.
- \* Individual monetary incentives are not the most effective way to make people work more productively.

### **Objectives of Pay**

Pay may have one or more objectives, which may often be in conflict with each other. The objectives can be classified under four broad headings.

The first is equity, which may take several forms. They include income distribution through narrowing of income inequalities, increasing the wages of the lowest paid employees, protecting real wages (purchasing power), and equal pay for work of equal value. Even pay differentials based on differences in skills or contribution to performance have a relationship to the concept of equity.

A second objective is efficiency, which is often closely related to equity because the two concepts are not antithetic. Efficiency objectives are reflected in attempts to link a part of wages to group or individual performance, acquisition and application of skills, and so on. Arrangements to achieve efficiency may be seen as being equitable (if they fairly reward performance) or inequitable (if the reward is viewed as unfair).

A third objective is macro-economic stability through high employment levels and low inflation, for instance. A high minimum wage would have an adverse impact on levels of employment, though at what level this consequence would occur is a matter of much debate. Though pay and pay policies constitute only one of the factors which impinge on macro-economic stability, they do contribute to (or impede) balanced and sustainable economic development.

A fourth objective is the efficient allocation of labour in the labour market. This implies that employees would move to wherever they receive a net gain; such movement may be from one geographical location to another, or from one job to another (within or outside an enterprise). Such movement may be caused by the provision or availability of financial incentives. For example, workers may move from a labour surplus or low wage area to a high wage area or to one with labour shortages. They may acquire new skills to benefit from the higher wages paid for skills. When an employer's wages are below market rates, employee turnover increases. When it is above market rates the employer attracts job applicants. When employees move from declining to growing industries, an efficient allocation of labour due to structural changes takes place.

### **Pay Reform: The Move To Performance Pay**

"We now pay workers not for output produced, nor even for labour input provided, but simply for time spent on the job."

(Alan S. Blinder ed. *Paying For Productivity*).

Traditionally wages and pay have been determined through government regulation, minimum wage determination, negotiation with unions, decisions of arbitration or labour courts in some countries, and the individual contract of employment. The factors or criteria which have influenced pay and pay increases include profit (but generally unrelated to individual or group performance), job evaluation, seniority, cost of living, manpower shortage or surplus, the negotiating strength of the parties and skills. Performance measures such as productivity or profit related to the performance of a group have been of less importance in determining pay increases. Though skills have been reflected in pay differentials, pay systems have been seldom geared to the encouragement of skills acquisition and application. Industrialized countries have built their competitive advantage

not around low wages, but around clusters of competitive industries in which high earnings and standards of living have been sustained through improved technology, productivity and quality. Many countries now recognize that high technology, productivity and low earnings cannot be combined and sustained over a period of time. As such, many employers are now seeking to sustain their competitiveness through pay increases which are more related to performance as a way of absorbing increased labour costs, while at the same time rewarding and motivating employees. Japan, Singapore and Korea, for example, have succeeded in moving to high value-added and technology-based or service activities partly because they had invested in skills development and accepted the fact that higher earnings are an essential strategy for entry into the knowledge-based industries of the future. Increases in real earnings have been made possible because investment in education and skills contributed to productivity enhancement which, in turn, created the capacity to absorb higher earnings. In the 1980s Singapore made a deliberate shift to a high wage economy in order to encourage entry into high value-added activities. Productivity increases are necessary to sustain higher earnings; at the same time long-term productivity growth usually results in an increase in real wages.

Traditional pay systems for non-executive staff have generally been characterized by standardization across and within sectors (e.g., government, particular industries) and within enterprises. So long as employers were competing mainly in domestic markets which were protected from foreign competition - in some cases leading to monopolies - the effects of standardization on considerations such as performance, recruitment and retention of good staff, etc. were less felt. Indeed, standardization, while being equitable from the point of view of some employees, benefitted employers as well by reducing competition based on labour costs.

With the gradual opening up of economies to world trade and foreign investment, local employers are now compelled to compete with enterprises with sophisticated technology, more productive ways of providing goods and services, and the advantage of being global players. In many instances these foreign enterprises are able to attract the best local talent on terms and conditions beyond the capacity of many local enterprises to pay. With the acceleration of the process of globalization and the movement of former centrally planned economies towards market economies, governments and private enterprises have had to compete in the global market by developing competitive advantages, which are affected by costs and quality. Productivity increase as the measure of performance at the national and enterprise levels, with quality as an intrinsic part of productivity, is becoming the goal of many developing countries as well - now pushed to the forefront by the forces of globalization and the collapse of economic systems which were alternatives to a market economy. Economies which are seeking to progress from low wage cost manufacturing to highly skilled and technology-based production need pay systems which not merely recognize skill differentials (as standard pay systems do), but also provide an incentive to acquire skills and multi skills facilitated by years of careful and correct investment in education and training.

While competitiveness has created organizational changes in respect of strategies, structures and cultures, compensation has lagged behind. It is in more recent times that pay has become an important part of organizational change. There is now a shift from

individual performance and responsibility to group effort, and therefore to team-work. This has had an impact on the type of compensation needed to match this shift. Pay is often viewed differently by different people in an organization. For example, senior managers may see it as a cost, line managers as an investment and HR managers as a means of attracting and retaining competent staff. Increasingly, it is recognised that pay is not only a cost, but also a tool in influencing performance. High-performing organizations are restructuring around teams and processes, rather than individual jobs, to achieve cost effectiveness, flexibility and improved quality of products and services, which require multi-skills and different motivators.

In the area of industrial relations, collective bargaining outside the enterprise is regarded by employers as achieving distributive justice in the sense of equality, with outcomes often being based on the bargaining strength of the parties. However, it is increasingly viewed as contributing little to productivity and performance. The outcomes often leave employers with little or no capacity to make further payments on account of performance under a scheme. The movement towards decentralization of collective bargaining has been the result of the need to address efficiency and performance issues at the enterprise level. It is natural that with decentralization employers would seek ways to introduce performance criteria into wage increases. In countries with high union density and a tradition of centralized collective bargaining, performance-related pay is less common. Though collective bargaining has yet to develop a significant role in performance pay determination, there are several indications that it is gradually adjusting to accommodating performance-related pay.

The increase in atypical forms of employment (e.g. homework) which cannot consistently or always be supervised, has also influenced the search for alternative forms of pay.

Traditionally increased earnings were secured, and performance rewarded, partly through promotions. With limitations on higher positions in the context of organizations becoming less hierarchical, relating a part of pay increases to performance would be a way of rewarding performance other than through promotions.

In these circumstances pay systems are increasingly forming a part of human resource management initiatives to achieve enterprise objectives and strategies, with attention being paid to how they fit into the overall human resource management policies of enterprises.

These developments have several implications for pay systems. Employers (and some governments) realize that pay increases need to be more than matched by productivity increases if competitiveness is to be achieved or maintained. The relationship among pay, productivity, skills and inflation was understood quite early in Asia by Japan as well as by some of the newly industrialised economies.

In the Asian-Pacific region, for example, the pressure for recognition of

performance criteria in pay determination has not come only from employers. In Singapore the government initiated the move to flexible pay in the mid 1980s. In Malaysia the government drew attention in 1988 to the desirability of introducing a flexible pay system. In Fiji the government has been exploring the feasibility of introducing performance pay into the public service, while encouraging employers to do likewise. The Minimum Wage Board in Papua New Guinea has, since the early 1990s, been required to relate minimum wages to performance criteria in place of indexation. In recent years the wage determination system in Australia has encouraged employers and unions to negotiate a part of wage increases in the context of productivity and productivity-related improvements. The fundamental shift of industrial relations to the enterprise level and the individualization of the employment relationship in New Zealand has provided ample scope for performance-related pay. Therefore it is increasingly recognized that performance and skills criteria need to be injected into pay determination; that it cannot be achieved through centralized or macro-level pay determination, and that changes have to be negotiated at the enterprise level. In other regions, too, there have been government initiatives. Fiscal incentives were provided in Britain and the Netherlands - in the latter case with little impact. Brazil has recently mandated negotiation by enterprises of profit sharing or gain sharing schemes. Further, some governments (e.g. Britain, Sweden and Canada) have introduced performance-related pay in the public sector.

Among the trends in pay are the following:

- \* while there must be a basis for pay differentials, it is necessary for pay systems to reflect a flexibility which cannot be achieved principally through job evaluation because it has been used to secure standardization.
- \* Seniority or length of service as a criterion in pay determination has diminished in importance, and more emphasis is now placed on contribution to performance. The system of granting employees automatic increments merely because of their physical presence in the workplace year after year is under attack.
- \* Especially in the case of non-managerial staff, the emphasis is increasingly on team rewards over individual ones, depending of course on the nature of the operations. On balancing the two reward methods, see Robert L. Heneman and Courtney von Hippel *Balancing Group and Individual Rewards: Rewarding Individual Contributions to the Team*. The problems of team-based pay relate to situations where some individuals receive a reward despite being low performers. In such instances the *free riders* can have a demotivating effect on those who perform.
- \* It is increasingly recognized that performance related pay, if used in isolation, has little impact on motivation or performance. Improvement in performance has to be secured through behavioural change effected

through a range of measures (including compensation), such as training (which helps to produce the requisite levels and types of skills and competencies) and better information/consultation/communication mechanisms. In a survey conducted among a sample of firms drawn from the Fortune 500 manufacturing and Fortune 500 service companies, it was found that the most widely used rewards for performance were non-monetary recognition awards, used by over 90% of respondents: Gerald E. Ledford, Edward E. Lawler and Susan A. Mohrman *Reward Innovations in Fortune 1000 Companies* @ *Creating High Performance Organizations: Practices and Results in the Fortune 1000*, summarized in 1995 (July-August) *Compensation and Benefits Review*76.

Among the Fortune 1000 companies, the trends between 1987 and 1993 were: a doubling of the firms using flexible benefits (i.e. ones which give an employee a choice of benefits up to a monetary limit) due to their advantage of cost control, and a 50% increase in resort to knowledge/skill-based pay.

In these circumstances a major concern for employers will be to negotiate pay systems which:

- \* achieve a strategic business objective;
- \* are flexible in that their variable component could absorb downturns in business and reduce labour costs;
- \* are oriented towards better performance in terms of productivity, quality, profit, etc;
- \* are capable of enhancing workers' earnings through improved performance;
- \* are capable of reducing the incidence of redundancies in times of recession or poor enterprise performance through the flexible component of pay;
- \* are able to reward good performance without increasing labour costs, and
- \* are able to attract and retain competent staff.

### **Objectives of Performance Related Pay and Its Relationship to Other Rewards and Strategies**

The broad objective of performance related pay is to provide rewards and incentives to enhance organizational performance through improved individual performance. This objective is achieved through a pay system with the following aims and characteristics. It should:

- \* have a strategic objective designed to achieve specific organizational goals by reinforcing or promoting them. The scheme should be tied to performance goals such as productivity and quality, profits.

- \* focus attention on the important performance issues, and thus make clear the organization's performance expectations.
- \* bring about changes in culture (e.g. team work, customer-orientation) or reinforce existing ones.
- \* enable the recruitment and retention of competent staff.
- \* underline the importance of not only individual performance but also its contribution to team work. Increasingly attention is being paid to the development of team-based pay with the recognition of team work as a key to organizational performance.
- \* provide higher earnings potential through rewards to employees, though differentiated in an equitable and consistent way according to their contribution. The reward would be financial or financially measurable, and would be linked to individual, group or organizational performance.
- \* be flexible in the sense that it contains a variable component which is affected by performance.
- \* control labour costs by absorbing the cost of the rewards in the benefits accruing to the organization from improved performance.
- \* form part of an overall human resource management system which includes intrinsic rewards. This is an important aim as extrinsic rewards alone do not provide a sustainable motivating environment.

One major research project in the USA by the non-profit Consortium for Alternative Reward Strategies (CARS) Research covered 663 plans in 372 companies involving a total of 10 million employees and total sales of US\$ 351 billion. The plans

covered 1.3 million employees in manufacturing and service industries, both unionized and non-unionized. It found that the most important objectives of the plans were, on a scale of 1 to 5:

- improving business performance (4.27)
- teamwork (3.87)
- making the link between performance and reward (3.76)
- communication (3.59)
- morale (3.57)
- retaining staff (2.62)
- attracting staff (2.2)

However, critical to the success of any performance-related pay system is the practical recognition that it is only one part of a reward system which consists of both financial and non-financial rewards. The non-financial part of a reward system would

typically address individual needs such as working in a team, responsibility, recognition, opportunity to influence decisions, skills development, career opportunities, and a sense of achievement. The financial part of it will address pay structures, performance and skill based pay and benefits. They represent the intrinsic and extrinsic incentives which seek to ensure superior performance through a motivational system.

The necessity to integrate reward and human resource management strategies cannot be over-emphasized:

Thus, resourcing strategies will identify the skills required by the organization; reward strategies will be concerned with the reward system which is most likely to attract and retain those skills. Human resource development strategies will consider broadly how the level of competence can be increased; reward strategies will address the question of how people will be motivated to extend their skills and how they will be rewarded when they have acquired them. Performance management strategies will determine how pay increases or other benefits should be related to performance assessments. Michael Armstrong *Human Resource Management: Strategy and Action*.

It is equally important to recognize that a performance-related pay system requires that there is in place a performance management system. Such a system should combine several elements such as the following (see Incomes Data Services Study 626 May 1997, UK on *Performance Management*):

- \* Organizational planning which includes setting objectives and identification of the main skills requirements. The latter involves job profiling and succession planning.
- \* Communication of objectives throughout the organization. Objectives set must relate to the organization's overall goals.
- \* Performance measures or ratings on which performance pay decisions are based.
- \* A balance between enterprise needs and individual aspirations.
- \* Devolution to line managers and individuals of responsibility for performance management.

A reward strategy, taken as a whole, should originate from business strategies and objectives; be in conformity with organizational culture, values and beliefs; be consistent with the requisite style of management; be tied to business performance; and drive and support the desired behaviour.

A reward system, of which performance-related pay is a part, is a means of achieving organizational goals through a larger HRM strategy. HRM has three basic goals

which contribute to achieving management objectives. (See David E. Guest). The first is integration of HRM in two senses: integrating HRM into an organization's corporate strategy, and ensuring an HRM view in the decisions and actions of line managers. Integration in the first sense involves selecting the HRM options consistent with (and which promote) the particular corporate strategy. The option is determined by the type of employee behaviour expected needed to further the corporate strategy. For instance, the HRM policies in relation to recruitment, appraisal, compensation, training, etc. differ according to whether the business strategy is one of innovation, quality enhancement or cost reduction. A strategy of innovation may require a pay system less influenced by market rates but which rewards creativity, and the pay rates may even be low so long as there are ways of making up the earnings package. A cost reduction strategy may lead to pay rates being strongly influenced by market levels. Similarly, training and development would receive less emphasis in a cost reduction strategy than in one where the objective is innovation or quality. But such integration is difficult without securing the inclusion of a HRM view in the decisions and practices of line managers. This requires that HRM should not be a centralized function.

A second goal of HRM is securing commitment through building strong cultures. This involves promoting organizational goals by uniting employees through a shared set of values (quality, service, innovation, etc.) based on a convergence of employee and enterprise interests, which the larger Japanese enterprises were particularly adept at.

A third goal of HRM is to achieve flexibility and adaptability to manage change and innovation in response to rapid changes consequent upon globalization. Relevant to HRM policies in this regard are training and multi-skilling, re-organization of work and removal of narrow job classifications. Appropriate HRM policies are designed, for instance, to recruit, develop and retain quality staff, to formulate and implement agreed performance goals and measures, and to build a unified organizational culture.

In considering pay and its effect on performance, it is probably necessary to make a distinction between developed and developing countries. In many of the latter where wages are low, financial rewards are likely to have a greater impact on motivation and performance. The reason is that in such countries employees have yet to satisfy their basic needs, and factors such as job challenge and the degree of responsibility may be relatively less important.

### **Problems and Issues**

Whether extrinsic rewards such as performance-related pay actually motivate employees to better performance is a matter of controversy. It has been claimed that monetary rewards usually have a limited time-span in regard to their motivating effect. Therefore extrinsic rewards such as performance pay, even if they can exert a continuing impact on performance, should

- \* be consistent with overall management objectives, so that performance pay may not be consistent with, for example, a purely cost reduction strategy;
- \* only be used to reinforce a motivational system in which intrinsic (non monetary) rewards exist, such as reorganization of work processes, training, employee involvement/consultation in decision-making, two-way communication, opportunities to contribute ideas, career development plans and goal setting.

Some of the reasons why performance-related pay fails and some problems and issues facing employers flow from circumstances such as the following:

- (i) Inadequate criteria to measure performance, or criteria which are not easily understood, communicated and accepted. Performance pay should therefore be negotiated.
- (ii) Inappropriate performance appraisal systems in that the objectives of the appraisal system (e.g. where it is intended to identify training needs or suitability for promotion) do not match the objectives of the reward system. In fact, the normal appraisal system should not be used to determine performance pay.
- (iii) The absence of regular feedback on performance.
- (iv) The reward system is not designed to meet the objectives sought to be achieved.
- (v) The absence of a right mix of extrinsic and intrinsic rewards.
- (vi) The lack of an appropriate quantum of pay which should be subject to performance criteria. This occurs when the amount which depends on performance is too small, or it is too large and therefore the amount placed at risk (when performance is poor) is not acceptable to employees.
- (vii) The absence of periodic evaluations of the scheme.
- (viii) Non-recognition of the fact that performance, especially profit, is sometimes (even often) dependent on factors outside the control of employees e.g. management decisions, exchange rates, recessions.

Two benefits at the macro level have been claimed for performance pay. The first relates to employment. If increases in basic pay are transferred to a profit-related scheme, the employer may be more inclined to hire new employees as his fixed wage cost is less than otherwise. If the percentage of profit to be shared remains fixed, additions to the workforce do not cost the employer more in terms of the profit-related pay. On the other hand, new recruitment would reduce the quantum existing employees will receive unless profits increase, and consequently dissatisfaction among employees could set in.

The second benefit is that increased earnings through a performance-related scheme will not result in inflationary tendencies as such increases will often be the result of increased productivity.

The benefits to management and employees are that:

- \* where performance/profits increase, higher earnings accrue to employees
- \* where profits reduce, the reduction in the performance-related pay can cushion employees against redundancies
- \* employee identification with the success of the business is enhanced
- \* variations in pay lead to employees becoming more familiar with the fortunes (or misfortunes) of the business. This would depend on the information-sharing practices of the management.

Several criticisms of a general nature (apart from those directed at particular types of schemes) have been levelled against performance-related pay. Among them are the following:

- (i) where the performance earnings fall, employees are inclined to expect increases in their guaranteed pay
- (ii) positive employment effects could be negated due to opposition from employees to recruitment as it would dilute their earnings
- (iii) since performance/profits depend on a variety of factors, some of which are beyond the control of employees, it is not possible to link pay to the performance of employees. If it is linked to the overall performance of the enterprise, then management decisions should logically be subject to scrutiny by employees.
- (iv) it is difficult to determine whether the amounts paid out under schemes are more than matched by performance gains.
- (v) individual performance is difficult to measure objectively, and an exclusively individual performance-related system can damage team work.

Even though the evidence is not always clear whether profit-sharing, for instance, raises productivity levels, the positive link between profit-sharing and productivity is clearer in enterprises with employee participation arrangements. Where the extra payments replace a fixed wage component and do not form an additional component of pay, there is a greater likelihood that the extra pay is matched by performance increases. In the case of group incentives, payments are not proportionate to individual performance, as poor performers ("free riders") benefit from the efforts of others.

Some objections to performance pay should be noted. First, writers such as Alfi

Kohn (*Punished by Rewards* and *Harvard Business Review*) contend that performance-related pay is only a short-term motivator at best. Second, it is claimed that such schemes can be expensive if the non-variable part of salary is too high. British Telecom, for instance, suspended its scheme for managers for this reason. Third, in some cultures (i.e. collectivist ones) financial rewards to individuals are said to have little impact. Thus Fons Trompenaars (*Riding the Waves of Culture*) says that

There are at least two sources of motivation. People work for extrinsic money rewards and for the positive regard and support of their colleagues. In more collectivist cultures, this second source of motivation may be so strong that high performers prefer to share the fruits of their efforts with colleagues than to take extra money for themselves as individuals@.

Southern Europe (e.g. Italy and Spain) and Japan are cited as examples of such collectivist cultures. Finally, in some assertions to the effect that performance-related pay has had an impact, it is not clear whether the failure was due to the absence of other needed changes in the workplace, or to the absence of a link between the business strategy and the pay system.

### **Performance Criteria Choices**

The nature of the business and operations, the type of employees and the objectives of a particular performance-related pay scheme will determine the selection of the criteria to assess performance. The criteria may be based on individual, group or organizational performance, or on a mixture of them.

Individual-related performance pay is more appropriate in circumstances where the contribution expected is directly attributable to the performance of individuals. Individual-based criteria would require individual goal-setting and an appropriate performance appraisal system; individual training to increase job knowledge and skills because training makes up the difference between abilities needed on the job and the abilities brought to the job; and the individual should have a large measure of control over his/her own performance. Individual performance criteria are not appropriate where the objective is to promote better overall performance through teamwork, cooperation, and the sharing of information and knowledge, or where individual performance is not measurable. In recent times rewards based on individual performance have come in for considerable criticism for reasons such as the following:

- \* difficulties in objective assessments of individual performance
- \* the tendency to undermine team-work
- \* encouragement given to individuals to focus on the short term

- \* the fact that individual rewards are more appropriate to small organizations requiring high levels of skill and knowledge

Team-based criteria are appropriate where individual performance is difficult to measure, or where there is a need for a corporate culture to promote team values and cooperation, or where the roles of individuals are more flexible, or where the expected performance depends more on team, rather than individual, efforts. The performance of the enterprise or of groups is easier to measure, and overall enterprise performance is the criterion in schemes such as profit-sharing. Such schemes are intended to share the achievements of the organization as a whole and seek to increase the commitment of employees to the organization. But individuals and groups would find it difficult to identify the link between their performance and that of the enterprise. The Institute of Personnel and Development in Britain prepared a guide on team rewards, the basis of which was research on approaches to team rewards in a number of institutions. The main findings and conclusions are in Annex A, which reinforces many general principles applicable to performance-related pay.

Reward plans also differ according to whether they are financial or operational criteria. Plans that use financial criteria measure profit or earnings or return on investment.

Plans based on operational criteria usually use a combination of productivity, quality, safety, attendance, customer satisfaction, cost reduction, volume or output. Still others use a combination of the two.

## **Types of Schemes and Performance Pay**

### **Types of Schemes**

The types of schemes which fall within the description of performance pay are varied. Broadly speaking, they consist of schemes designed to share with or distribute to employees the financial results of enterprise performance. In essence, performance pay is based on paying the worker for his or her value, rather than the value of the job. Such schemes fall into the following broad categories:

- \* individual-based or based on individual performance, such as incentive schemes and sales commissions.
- \* profit-sharing, which may take the form of cash or shares related to profits. It takes the form of a pre-determined formula which relates the pay to profits.
- \* gain-sharing measured by a pre-determined performance formula, applicable to all or groups of employees. It involves a bonus plan based on the financial gains from increases in productivity or added value or other performance measures.

- \* employee share option schemes, which usually provide incentives with the option to purchase shares at a future date at the present market price.
- \* skills/competence based pay, which rewards employees for the acquisition and application of skills or for competencies.

## **Merit Pay**

A common method which has long been in existence is pay increases in the form of merit pay for individual performance. Its workability and effectiveness depend on the existence of a suitable performance appraisal system, which has often been found to be lacking. Due to its integration into the salary, it is not lost due to subsequent poor performance, and therefore ceases to be an incentive. However, merit pay may be distinguished from some other methods which reward performance in that it is more tied to behavioural characteristics such as time-keeping, attitudes, etc.

## **Incentive Payments**

Lump sum payments (such as sales commissions) is another traditional method. It is not added to base pay. Usually the formula and the relationship between performance and the payment of the lump sum are known beforehand.

Sales commissions may often have little to do with performance because factors such as product quality, brand name and price may contribute more to sales than the ability to convince buyers. Appraisals are less significant to this category where the criteria (e.g. sales figures) are statistical and no further measurement is needed.

Another traditional method of rewarding performance is piece rates. Unless related to a reasonable time frame within which the production should be completed, such rates would not be related to performance. There are several weaknesses in piece rate systems:

- \* it is not often easy to agree with workers on the standard output required
- \* frequent changes may be needed in the standard output due to technology changes, and this can invariably lead to disputes
- \* factors other than individual performance affect output e.g. new work arrangements
- \* where team work is an organizational goal, individual incentives can be

counter-productive. In such cases piece-rates should be based on group output.

- \* piece rates can generate conflict and be divisive. Employees sometimes seek to lower the standard output. Conflicts between different work groups occur when one group is dependent on another. There is a potential for conflict when norms have to be revised.
- \* piece-rates could be a disincentive to employees developing more productive work methods
- \* automation and other technologies have reduced the relevance of piece rates.

Generally speaking, many incentive schemes are appropriate to measurable repetitive tasks. They are not suitable for high technology and service activities requiring information-sharing, problem-solving and team work.

### **Group Incentives and Productivity Gain-Sharing**

Group incentive schemes are broadly of two types. Gain-sharing refers to a compensation system which divides between the employer and employees the results of improved performance consequent upon the better use of human resources resulting in productivity gains. Sharing is according to an agreed, pre-determined formula. A second type, namely, profit-sharing, gives employees a share of the profits. Sometimes bonuses are paid to individuals based on their own performance appraisal ratings. In the case of group incentives, the criteria could be either group or enterprise performance.

The necessity for objective criteria for distribution of the performance component of pay, and a clear relationship between what is paid and the criteria, are important.

Productivity gain-sharing has been practised by the larger Japanese companies. Their system is based on the premise that basic to successful productivity enhancement in the long term is sharing productivity gains with employees by linking a part of earnings to productivity to achieve such multiple goals as

- \* increasing labour productivity
- \* improving employees' living standards
- \* strengthening employee commitment
- \* improving labour-management relations
- \* securing flexibility in labour costs
- \* maintaining corporate viability

In the Japanese system a part of productivity gains is shared with the employees

through the collective bargaining process on whatever criteria are applied in collective negotiations, and a part through the gain-sharing system. The amount distributed in recent years through the collective bargaining process and the gain-sharing system in manufacturing establishments with more than four employees has been about 35% of value added. In the 15 years prior to about 1993, the share allotted to labour remained stable. The two mechanisms - collective bargaining and joint consultation on gain-sharing - have supplemented each other, and have contributed to establishing a consensus on criteria for pay increases.

The component linked to productivity is paid in the form of a bonus, which in years before the recent recession, represented approximately 3-5 months' pay. About one-third of companies employing 30 or more persons have productivity-linked schemes. The percentage has been much higher in the larger companies.

Some companies combine productivity and merit rating. Though linked to productivity, the amount may be distributed on a merit rating arrived at through the joint consultation system and reviewed annually. Distribution of the productivity bonus may be direct to individuals, or first to the department or unit based on its performance level.

In Japan participation of employees in formulating and monitoring formulae has enabled them to:

- understand downturns and upswings in business cycles
- take a long-term view of growth
- be motivated through the opportunities offered them to influence the schemes
- achieve a common understanding of issues important to gain-sharing such as
  - \* concepts and measurement of productivity
  - \* the relationship between pay and productivity
  - \* estimates of labour costs and share
  - \* productivity improvement methods and targets
  - \* appraisal of the system

In general, gain-sharing systems are based on a participatory approach, and can be used to create or reinforce participatory practices. Evidence (e.g. in the USA) indicates that such systems

- \* improve coordination, team work and knowledge-sharing
- \* satisfy social needs (through participation)

- \* focus on cost saving
- \* facilitate changes (e.g. in technology) needed to improve performance which are seen as being directly related to higher earnings
- \* result in expectations by employees of better management and planning
- \* result in contributions of ideas by employees.

### **Profit Sharing**

These schemes are not related to an individual's performance, but are linked to the profits of an enterprise, a part of which is paid as a bonus to the workers. It may be a cash payment, or a deferred payment kept, for instance, in a special fund for a particular period. There are numerous types of schemes in existence. It has been estimated that by 1988 about half a million American firms were operating profit sharing schemes.

In the UK in 1991, the Government facilitated profit-related pay by providing tax exemption up to 20% of total pay received through an approved profit-related pay scheme. Consequently, between 1990 and 1995 there was a substantial increase in the number of employees covered by such schemes - estimated as an elevenfold increase.

### **Long Term Incentives**

Long term incentive plans are operated, especially for executives, both as an incentive to improved performance and in order to reduce fixed costs. Examples of such schemes are:

- \* share option plans to promote convergence of stockholder/executive interests
- \* bonus linked to long term performance (3-5 years) to encourage a focus on long term goals

In the 1980s stock ownership plans (ESOPs) in the USA normally included only executives, while in Japan they usually excluded executives. A lower rate of termination of ESOPs in Japan contrasted with a higher rate of terminations in the USA.

### **Performance Bonus**

This type of bonus can be based on individual or group performance. Where it is individual based, the payment would depend on performance ratings. Since the 1980s there has been in the USA an increase in union agreements substituting bonuses for traditional wage increases. In many countries performance bonuses are commonest for executive staff. It is estimated that in the USA about 97% of the large, and 86% of the

medium-sized companies pay such bonuses to their executives. In Western Europe the estimate is about 70% and in Singapore about 66%. As a percentage of base pay, the figure is highest in the USA, though the variations are also large.

Some of the criteria for the success of such bonus payments are: group over individual performance, the existence of objective criteria for distribution, and the fact

that such criteria are capable of measurement to ensure that what is paid is related to such criteria.

### **Flexible Benefits**

Flexible benefits refer to a system which allows employees some control or choice over how the benefits part of their total compensation package is distributed using the quantum of money available for benefits such as health insurance, holidays, etc. Such schemes work on the principle of the employer attaching a financial value to each benefit and arriving at a maximum monetary value for the totality of benefits. An employee can then choose from among the menu of benefits, allocating more resources to one rather than another benefit. In this way employees are able to take into account their individual and family circumstances to maximise benefit from the package. For example, if A is covered by health insurance by his own firm but is also covered by the scheme applicable to his/her spouse working in another firm, A could shift the resources put into his health care plan to increase some other benefit such as a holiday package. Since there is a ceiling on the monetary value of the total benefits package, the employer's financial outlay does not increase. However, this type of flexible benefits plan does not strictly belong to the category of performance pay as the benefits in question are not related to performance. But it is a way of compensating employees while at the same time controlling costs.

### **What Is Skill-Based Pay?**

Skill-based pay refers to a system which promotes workforce flexibility by rewarding individuals based on the number, type and depth of skills acquired, mastered and applied. The pay increases are usually tied to four types of skills:

- \* horizontal skills, which involve a broadening of skills in terms of the range of tasks across several jobs, e.g. in the field of accounts.
- \* vertical skills, which involve acquiring skills of a higher level within a single job
- \* depth skills, which involve a high level of skills in specialised areas relating to the same job, e.g. a computer programmer specializing in data base programming
- \* basic skills, which involve developing expertise in basic skill areas, e.g. maths, fluency in a particular language.

Skill-based pay differs in the following respects from traditional pay systems which reflect skills differences in a structure consisting of rates of pay for unskilled, semi-skilled and skilled workers:

- \* Skill-based pay is a person-based and not a job-based, system. It rewards a person for what he/she, rather than the job, is worth. Job worth is reflected in a basic rate of pay for minimum skills, but pay progression is directly linked to skills acquisition (rather than to general pay increases applicable to all) .
- \* It rewards (and therefore emphasizes) a broad range of skills which makes the employee multi-skilled and therefore flexible.
- \* It positively encourages skills development.
- \* A skill-based pay system must consist of performance measures which reflect how well the skill is used, since what is paid for is the *application* of the skill leading to improved performance.
- \* The system needs to be underpinned by opportunities for training, critical to its success.

Skill-based pay is distinguished from competency-based pay. The former, though person-based, defines the specific skills required at a particular point of time. Competency based pay, which is a development of skill-based pay, targets knowledge workers, including engineers, research and development staff, other professional executives and managers whose required attributes are less precise, which makes performance measures much more difficult. There is considerable difficulty in arriving at an adequate definition of competencies for this purpose. One view is that competencies broadly refer to such characteristics a person has, such as knowledge, skills and behaviour, which are demonstrated and lead to performance. (See Gerald E. Ledford *APaying for the Skills, Knowledge, and Competencies of Knowledge Workers*.)

A further development is the increasing interest in competency-based pay, due to the decline of distinct and separate jobs round which pay, training and development, career plans, etc. were built. Therefore, the alternative is to build human resource practices around skills, knowledge and competencies. Further, with the popularity in recent years of developing *Acore competencies*@as the definition of business strategy, competency-based pay has become attractive. Though still lacking adequate research, it is probable that competency-based pay will become important in the future.

### **Reasons For Skill-Based Pay**

More than ever before in workplace relations, a commonality of interests in the skills of employees has developed between employers and employees. Skills provide employees with a measure of protection against unemployment, as well as opportunities for higher earnings. At the same time, skills provide employers with an important means of achieving competitiveness.

Many countries today are seeking to advance to more technology and skill-based

industries, while others have become (or are becoming) 'post industrial' societies, in which the application of knowledge determines productivity and competitiveness. Comparative advantage based on, for instance, cheap labour or raw materials has declined in importance relative to competitive advantage based on the ability to add value to a particular resource or advantage. Such comparative advantage partly (often largely) depends on people - their standards of literacy and education, work attitudes, value systems, skills and motivation. Critical today is the ability to innovate and develop clusters of competitive enterprises in particular industries. For the more industrialized countries this means 'capturing' some of the key industries of the next century - micro-electronics, biotechnology, new materials science industries, telecommunications, civil aviation, computers and software, robotics and machine tools and entertainment. An employee with skills is most flexible and productive when he develops a broad range of skills, is able to learn the next higher skill, develops analytical skills and is also able to work in a team. Important aspects of today's skills package include multi-skills, cognitive skills, interpersonal and communication skills, positive work attitudes and quality consciousness. Training is no longer only for current competence, but is also to prepare for the next stage of skills. Thus pay systems which promote current and future skills needs are increasing in importance.

The impact of rapid technological change, the increasing globalization of product markets, greater customer choice and the emphasis on quality, necessitate a frequent updating of skills, and flexibility to respond to rapid changes in the requirements of markets. A flexible workforce, which is one that is multi-skilled, ensures that production is not interrupted due to the narrow skills of workers, and that workers are themselves responsible for the quality of products.

### **Advantages Of Skill-Based Pay**

Among the advantages of skill-based pay are the following:

- \* It contributes to job enlargement, enrichment and satisfaction by breaking down narrow job classifications.
- \* Flexibility is increased by encouraging the performance of multiple tasks, fewer job classifications, job rotation, and filling of temporary vacancies due, for instance, to absenteeism. It therefore contributes to a leaner workforce.
- \* It enhances productivity and quality through better use of human resources.
- \* It facilitates technological change, which may meet with resistance in a purely job-based system.
- \* The higher pay levels, continuous training, and job enlargement through the broadening of skills tend to reduce staff turnover.

- \* Elimination of unnecessary jobs can result from a workplace having broad, rather than narrow, skills. It also reduces the need for supervision.
- \* Job satisfaction is engendered through employees having greater control over the planning and implementation of their work.
- \* Broadening of skills leads employees to develop a better perspective of operations as a whole.
- \* It is an incentive for self-development.
- \* It provides employment security (employability) through skills enhancement.
- \* It reduces the need to look to promotion to higher levels (which are always limited) as the only way to enhance earnings, and it facilitates the planning of an employee's career development path.
- \* Since the reward flows from the application of a skill and it does not reduce opportunities for others to similarly increase their skills and earnings, there is likely to be less competition among individuals.
- \* Since the pay increases on account of skills are linked to a measurable standard, the criticism of subjectivity often associated with performance appraisals and individual-based performance-related pay is avoided.

### **Introducing the System**

Introducing a skill-based pay system requires several steps to be taken and several issues to be addressed:

- \* The skills requirements of the enterprise should be analysed
- \* The availability of resources for training should be ascertained
- \* The jobs to be covered by the scheme should be identified
- \* Usually jobs have to be redesigned
- The individual jobs have to be grouped into 'job families' on the basis that in each 'family' the skills needs are similar. The skills within each job family and the tasks needed to perform the job should be analysed
- 
- \* The above will lead to an identification of the skill blocks or levels. The skill level is the pay grade relative to the competence to use particular skills, and the skill block is the training input which has to be completed to the

satisfaction of the certifying system in order to gain entitlement to the extra pay. It is not unusual for skill levels to consist of several skill blocks, each to be acquired through training.

- \* Training modules have to be formulated
- \* The way in which certification is obtained that the skill has been acquired should be agreed upon.
- \* The base rates for 'job families' have to be set, as well as the payments that will be made thereafter when an employee moves upwards through the skills route.
- \* The criterion for extra payment is not acquisition of the skill, but its application.
- \* The period during which the skill should be applied before a new one is acquired should normally be decided on, as the skill should benefit the employer who should receive a return on the investment made.
- \* A difficult question is how obsolete skills should be dealt with e.g. through retraining or redundancy.

### **Problems In Skill-Based Pay**

There are several problems associated with the introduction of skill-based pay which should not be underestimated. They can be extremely costly having regard to

- the extra payment involved
- training costs
- the fact that some skills may be paid for but used infrequently
- the possibility that unusable skills may be acquired unless the system is properly administered
- the fact that it is not always easy for an employer to anticipate accurately what skills will be needed in a few years' time

The administration of the system is complex, both in regard to certification of skills acquisition and payment. Therefore, unless administered properly, the costs can outweigh the productivity and flexibility gains. Further, the employees who reach the maximum of the skill levels can be demotivated when extra payments, as distinct from general pay increases, cease. Therefore the gains from flexibility, improved quality, the elimination of some jobs and so on depend on the employer's ability to administer the system properly,

making clear also that it is not the acquisition of **any** skills, but agreed relevant skills, that fall within the scope of the scheme. Hence the need to negotiate the system. It is easier to introduce skill-based pay in an entirely new (greenfield) site, than in an already existing one where there is already a pay system based on different criteria.

### **Factors For Success**

Some of the circumstances which contribute to the success of skill-based pay are:

- \* the employer's commitment to continuous training and development
- \* the value attached by the employer to personal growth and the encouragement of a learning orientation
- \* dismantling of strong bureaucratic hierarchies and narrow job demarcations
- \* participative management practices, independent and cooperative forms of work.

### **Appropriate Industries**

Skill-based pay systems are most appropriate to enterprises which depend on a high level of skills, and in which labour costs represent a relatively small portion of total costs, unlike in labour intensive industries. Though such pay systems have been commonest in manufacturing organizations, they are applicable to service industries as well though the objectives may differ. In banks and airlines, for example, skill-based pay can be used to encourage people to work in areas where manpower is most needed at a given point of time due to customer flows. Skill-based pay is particularly consistent with knowledge-based work. It has generally been regarded as inappropriate in highly automated situations where employees have little effect on operational performance. It operates best in relatively small locations with not more than about 500 employees.

### **Conclusions and Guidelines**

The success or failure of performance pay is affected by a variety of circumstances which vary from country to country. Therefore, transplanting such systems without adapting them to an enterprise's needs is unlikely to meet the objectives. Success or failure will generally be influenced by circumstances such as

- \* the tradition of collective bargaining.
- \* attitudes of unions. For example, the negative attitude of unions in Malaysia hindered its introduction in that country, while the opposite attitude of the

union in Singapore considerably facilitated it.

- \* cultural factors. For instance, group incentives may be more appropriate in some cultures.
- \* a human resource management strategy which uses pay to reinforce larger business strategies. Thus organizations which are in low cost manufacturing, or which promote innovation, skills and higher performance, or which are in service industries may need to consider different forms of performance pay. Their business and human resource management strategies will differ, and pay objectives should be consistent with them.
- \* whether the overall climate in the enterprise is favourable to performance and productivity. For instance, enterprises which encourage employee involvement policies and practices have experienced better results with performance pay.
- \* whether the enterprise is in a developed or developing country. The level of education of the workforce, for example, would affect what type of scheme is likely to be easily understood.
- \* the nature of the business and the operations.

It is necessary to bear in mind that performance is affected by a variety of factors such as

- \* knowledge or skills which determine the potential to perform, and which need to be developed through training;
- \* work attitudes which determine willingness to perform, and which therefore have to be matched by appropriate motivational systems with intrinsic rewards; and
- \* the ability to match the above factors which secures performance, and is consequently a central task of human resource management.

On the controversial issue of whether reward systems do motivate, it is essential to pay attention to aspects which are equally - perhaps even more - important than the rewards themselves, such as:

- \* reorganization of work processes
- \* training
- \* employee involvement and participative decision-making
- \* opportunities to contribute ideas and knowledge

- \* non-monetary recognition
- \* career development
- \* goal setting

The following tentative guidelines are suggested:

- (1) A performance pay system should be designed to promote the kind of performance an organization needs. In order to do so
  - an analysis should first be made of the objectives and results sought
  - the principles/policies and practices needed to obtain the results (e.g. team work) should be established
  - these policies and practices should form part of an overall human resource management strategy, and should be integrated with the main strategies for growth and better performance.
- (2) The performance pay system should underpin the organization's main values, in particular ones relative to team work, flexibility, innovation and quality.
- (3) The system should be an impetus to, and support, the behaviour sought to be achieved. Therefore, it must communicate to employees
  - the type of behaviour to be rewarded
  - how such behaviour will be rewarded
  - how employee expectations will be satisfied.
- (4) The intrinsic reward system should be strengthened, e.g. through
  - consultation, communication, participatory systems
  - training
  - job satisfaction and responsibility
  - reorganization of work processes
- (5) Employees should be consulted in the formulation of the plan (to ascertain the type of rewards most likely to have motivational effect), in regard to its operation and distribution of rewards, and in monitoring the scheme.
- (6) The criteria for the determination of performance pay should be
  - objective
  - measurable and measure only what is important
  - operated along with an appraisal system which measures performance appropriately

- designed to feed back information to employees, and not only to management
  - easily understood
  - related to what is controllable, so as to exclude what is beyond the control of employees.
- (7) How the performance pay is shared is as important as the quantum, because the manner of sharing affects employees' perceptions as to whether the scheme is equitable.
- (8) The impact of the scheme also depends on the frequency of the payment. Therefore the reward should follow the performance as soon as possible, except where the nature of the reward makes this not possible.
- (9) The scheme should be given wide publicity within the enterprise.
- (10) The performance level should be achievable or else the scheme will have no motivational impact.
- (11) The quantum of pay on account of performance which is placed at risk (*i.e.* the amount that can be lost due to poor performance) should be carefully determined. At the same time, the scheme should be sufficiently flexible to absorb downturns and adequately reward when performance is good.
- (12) The organization must receive value for the money it expends.

**Annex A****Summary of Research Findings and Conclusions  
on Team Rewards by the Institute of Personnel  
and Development, United Kingdom**

Source: The IPD Guide on Team Reward (Institute of Personnel Development, London, 1996)

The IPD research led to the following findings and conclusions:

- \* Of the 98 organizations in the UK surveyed, formal team pay schemes were found to exist in 24% of the firms. However, there was increasing interest in team pay, reflected in 47% of the respondents contemplating introducing it.
- \* No standard model of, or approach to, team pay is possible because of the varieties of both teams and schemes.
- \* Successful team pay requires satisfaction of many conditions which are not easy to fulfil. It depends not so much on the mechanics of the scheme but on the organization's culture, management style, working environment, structure, operating processes, the performance management system, and the programmes for employee development.
- \* Improvement in team performance does not depend only on reward processes. To plan and implement improvement programmes which teams are quite capable of doing themselves, they must have easy access to feedback information; opportunities to meet, discuss and evaluate on a regular basis their own performance; and decide on action needed.
- \* More than half the organizations operating a team pay system believed that it is contributing to improved team performance.
- \* A major problem was the extent to which team pay should replace individual performance pay. Many, including team members, were against a system that does not reward individual contribution, though the team pay ultimately goes to individuals. There is increasing resort to skill or competence based pay to reward individuals, in addition to their participation in the team pay earned.
- \* Performance management systems often include as an input an employee's ability to work in a team.
- \* Several persons expressed the view that pay is either inadequate or inappropriate in improving team performance. Non financial rewards were considered by them as either

substitutes, or as necessary along with team pay.

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