INTERNATIONAL LABOUR OFFICE

ISSUES, PROBLEMS AND TRENDS IN PERFORMANCE AND SKILLS BASED PAY SYSTEMS

By

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FOREWORD

Pay systems, methods of determining remuneration and the use of remuneration to achieve strategic corporate objectives have received increasing attention, particularly in industrialised countries. The interest that performance and skills based pay systems has generated among employers and their organisations in Asia and the Pacific, and the many requests which have been received for information and ILO programmes on them have led Mr. S.R. de Silva, Senior Speciallist in Employers' Activities in the ILO East Asia Multidisciplinary Advisory Team in Bangkok, to write this book on the subject. It will be used as training material for employers' activities and for dissemination as knowledge-based information. I am confident that the information and analysis will also be of interest to persons outside employer circles.

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ISSUES, PROBLEMS AND TRENDS IN PERFORMANCE AND SKILLS BASED PAY SYSTEMS

A. INTRODUCTION

"Because pay systems represent a significant cost for most organisations they receive considerable attention but often with the wrong emphasis. Too much attention is focused on reducing pay costs and too little is focused on increasing the benefits of the pay system. A well-designed pay system can be a very important contributor to an organization's effectiveness. The challenge is to align an organization's pay system with that organization's strategic direction. This is not easy to do—if it would be common practice—but it can be accomplished".¹

Compensation has been a relatively neglected management tool in strategic human resource management policies and practices to achieve overall enterprise results and enhanced performance. This is partly due to the fact that in many countries a large part of non-executive pay is determined through negotiations with trade unions on criteria which have relatively little to do with rewarding the contribution employees individually or as a team or as a group make to an enterprise through their performance and skills. Except for basic incentive and piece-rate systems, until fairly recently strategic pay has not been a priority on the agenda of many managements even in industrialised countries, although pay has a substantial impact on the world of work. Most of the exceptions are in any event of fairly recent origin, but currently the subject is generating considerable interest and experimentation in several countries. Japan has for a few decades practised gain-sharing and has successfully combined collective bargaining, seniority criteria and performance in determining gross earnings. In the USA hundreds of thousands of organisations have, in the last one and a half decades, implemented a wide range of schemes to reward
performance. Studies conducted in the USA\(^2\) among college students, line managers and compensation managers indicate a generally shared view that performance should be the most important consideration for pay increases. An equally important reason for the relative neglect of strategic pay is the preoccupation of enterprises with what other enterprises are doing in the area of pay, rather than with re-aligning their pay system with organization goals.

This section seeks to establish a common understanding of terms and the general context in which the subject matter needs to be considered. The terms 'strategic pay' and 'person-based pay' will be used interchangeably to encompass pay for performance, skills and knowledge. 'Merit pay' will be used to refer not to pay based on skills and educational factors, but to pay increases based on individual or group performance.

There is probably no aspect of terms and conditions of employment which influences the world of work as much as pay systems do. Pay also needs to be viewed in the context of equity, fair distribution of resources available for remuneration and as one means of satisfying needs in different ways at different levels in the hierarchy of needs. Therefore in the final analysis, the dilemma is that a strategy relating to pay would be effective only if the pay itself and its distribution are perceived as fair by the recipients, and at the same time it achieves the strategic objectives of the employer. A consideration of the factors which usually determine pay indicates the difficulty of arriving at a consensus about the fairness or unfairness of a pay system. These factors are broadly:

(i) Needs, i.e., the pay should satisfy, as far as possible, the different needs of people.
(ii) Job content and the value of the job to the enterprise.
(iii) Skills requirements.
(iv) Performance of both the employees and the enterprise. Cognizance should also be taken of the employer's financial capacity.
(v) The labour market situation. This includes pay for comparable jobs in comparable enterprises. It would also take into reckoning skills shortages as they would have a bearing on pay determination.

The difficulty of achieving a satisfactory balance in relation to these factors is self-evident.

This study commences with an examination of some of the reasons for the heightened interest in, and push (by employers) for, person and group based compensation systems linked to performance and skills. Some of the weaknesses of standard payment systems are analyzed next as an appreciation of them is necessary to explain the interest in, and significance of, person-based pay systems. Strategic pay systems are beset with numerous problems, inadequate attention to which explains some of the failures. Employers have to make many strategic choices in introducing performance and skills based pay, and those decisions can seal the fate of the system one way or another. Therefore these choices are covered next. Particular types of performance pay are then described, after which skills and knowledge based pay systems are analyzed. A few trends in some countries are identified, and the study closes with a few conclusions.

B. FACTORS INFLUENCING CHANGE AND SOME TRENDS

In the industrialised market economies of the West, the most entrenched system through which wages are determined for non-supervisory and non-managerial employees is collective bargaining. To trade unions it represents a tool for sharing rule-making power pertaining to terms and conditions of employment and it represents their most central role. For workers and unions, collective bargaining ensures a measure of equalisation of wages and salaries across the national economy, industry and within the company. From the employers' point of view, by achieving a degree of standardisation of wages, collective bargaining reduces competitive advantage based on labour costs. This consideration is seen as less important to employers today, and competitive advantage is to a large extent based on productivity and quality which ultimately affect the costs
of labour, especially in high value added industries. Further, pay increases through collective bargaining have largely concentrated on criteria such as satisfying distributive justice, compensating for inflation and cost of living, and payment for comparable jobs in the labour market. This is particularly so where collective bargaining takes place at the national or industry level, as agreements at such levels provide no scope for paying due regard to performance of individuals or groups within an enterprise, or for aligning pay increases to corporate goals of individual enterprises. The increasing trend in the 1990's towards enterprise level bargaining is in itself an outcome of the recognition that decentralization of decision making is necessary not only in relation to decisions within enterprises, but also in relation to decisions taken outside the enterprise but which affect both management and employees in the enterprise.

In some countries, including several developing countries, industrial court and arbitration systems have also had an impact on pay increases and other benefits. This method of adjustment has, in most countries, not addressed any of the problems sought to be solved through a strategic pay system such as motivation, productivity and controlling labour costs while at the same time ensuring higher earnings.

During the last two decades there has been a substantial increase in emphasis on human resource management as an integral part of corporate strategy, with its gradual integration into line management. The objective of human resource management is not to secure compliance with rules and procedures but to secure performance and commitment through a variety of strategies and the creation of an environment conducive to the attainment of these objectives. Industrial relations emphasises collective relations between employers and employees and their organisations, and between them and the State. Collective bargaining, as one of its cornerstones, is an aspect of collective employee relations. Current trends include a shift from this approach to employee management, to a more individualised system of employee relations, which represents one difference between industrial relations and human resource management. Many subjects falling within the latter such as selection, recruitment, induction, appraisal, training (arguably one of its most central themes), career development and, to a great
extent motivation, are directed at the individual. A more collectivist aspect of human resource management is reflected in its other activities of team building, cooperation and communication.

A well known human resource management cycle is illustrative of the above:

\[
\text{SELECTION} \quad \rightarrow \quad \text{PERFORMANCE} \quad \rightarrow \quad \text{APPRAISAL} \quad \rightarrow \quad \text{DEVELOPMENT} \quad \rightarrow \quad \text{REWARDS}
\]

Appraisal and development are directed at individuals. Though rewards are not always so directed - since bonuses and especially wages and salaries are also directed towards groups of employees - there is a trend towards 'individualisation' of monetary rewards, e.g. skills and performance based pay. Collective bargaining has been concerned with equal distribution and satisfies equity in the sense of equality. How to balance equity in this sense with efficiency has become a current concern.

In industrialised countries the trend towards individualisation of employee relations coexists with collectivist industrial relations. Unions see the individualisation of employee relations as 'marginalising' trade unions, which can therefore create some 'tension' between industrial relations and human resource management. In the majority of ASEAN countries the low unionisation rate reduces the scope for collective bargaining, but provides considerable opportunity for more flexible remuneration systems. Singapore, with the highest rate of unionisation in ASEAN, has practised collective bargaining, sometimes within guidelines issued by public authorities. This fact has not prevented the emergence of a trend towards an individualised compensation system, partly due to the practice of tripartism on matters ranging from wage fixation to productivity promotion and improvement. Such schemes are not introduced unilaterally but are discussed with the other social partner at national, industry or at enterprise level.

Generally speaking, public sectors are relatively exempt from these trends, partly because in many countries public sector remuneration is
standardised with less scope than in the private sector for individual units to change their way of granting increases in pay. In recent times, however, the civil service in some countries such as Britain has introduced performance pay systems in relation to some portion of pay increases. In many countries unionisation is higher in the public sector than in the private sector, so that departing from traditional pay systems may sometimes be more difficult in the public sector. But even where higher unionisation in the public sector is not a feature, public sectors are usually not known for innovative uses of management tools to increase productivity, earnings, performance and skills. The bureaucratic and hierarchical management structures of many public sectors are an obstacle to a departure from standardised pay systems.

There is greater recognition today that the centre of gravity of industrial relations is the workplace, resulting from globalisation and intense competition among nations and enterprises, and the need for more innovativeness and productivity. The application of knowledge and skills, in addition to product development and marketing, are among the most important factors in achieving competitive edge. Employers are taking a fresh look at pay systems as a means of increasing their competitiveness in the global marketplace. Globalisation has compelled unprecedented attention being paid to skills and quality as being critical to productivity, which is one of the major factors determining the competitive edge of nations and enterprises. The issue therefore is whether traditional compensation systems based on job value rather than on individual or group performance or contribution, and which therefore provide little scope for compensating for individual skill and performance, are sufficient to motivate better performance, skills acquisition and their application. Payment systems based on the position of jobs in the hierarchy of an organisation are increasingly seen to be inadequate in enterprises whose strategic human resource management policies and practices are oriented towards flexibility, employee involvement and commitment to quality. Thus some pay experts believe that:
"Pay programs can motivate employees to perform more effectively. They can create a culture in which people care about the organization and its success. They can provide the fringe benefits that individuals want in a cost-effective manner. They can attract and retain the kind of talent that an organization needs in order to be effective. They can encourage people to develop their skills and abilities in areas that will best aid the organization. Finally, they can create for an organization a cost structure that is realistic given the kind of environment that it faces".

Pay or labour cost flexibility is the result of increasing employer dissatisfaction with automatic pay increases (e.g. through indexation) or with increases which do not adequately take into account performance and skills, and a preference for systems linked to productivity, skills, performance (individual, group or company) and results. In countries experiencing skills shortages as their activities continually require higher levels of skills, this factor may also contribute to the introduction of strategic pay systems as a way of retaining core staff. Increasing atypical forms of employment are also likely to give a further impetus to strategic pay systems. Homeworkers and part-timers, for instance, whose numbers are on the increase and who are estimated to form about a half of the workforce in some of the industrialised countries, cannot effectively be supervised in terms of time. In their case, other considerations such as results may be a more important determinant of remuneration and remuneration increases.

C. STANDARD PAYMENT SYSTEMS VERSUS PEOPLE BASED PAY

For many decades one standard method of determining the base wage or salary of employees has been the technique of job evaluation, followed by job analyses and job descriptions, on the basis of which the relative value of jobs is assessed and pay levels set. The assessments made are of jobs and not of people's contribution to them. "Status, not contribution, has traditionally been the basis for the numbers on employees' pay
checks. Pay has reflected where jobs rank in the corporate hierarchy - not what comes out of them". However, this does not mean that a proper job evaluation exercise results in jobs being tied to status. Properly conducted, job evaluation should help to determine the value of the job. But the importance of job evaluation as a means of determining base pay should not be over emphasized. It has not been a technique in all enterprises, and are more common in the multinationals and in large national enterprises. In many national enterprises it has been used largely in relation to executive jobs.

Notwithstanding the merits of the job evaluation system which satisfies the criteria of objectivity and internal consistency, it suffers from limitations which have emerged in the context of the changes brought about by the factors already discussed. The concerns connected with the traditional methods of pay determination are expressed by Rosabeth Moss Kanter as follows:

"...first, cost the concern that the present system is too expensive for companies that must conserve resources to be competitive; second, equity, the concern that the present system is not fair; third, productivity, the concern that the present system is insufficient to motivate high performance; and, fourth, entrepreneurial pressure, the concern that the present system does not adequately reward people for creating new sources of business. In short, pay systems are under attack for neither being cost-effective nor motivating people to do more".

Determining base pay through the job evaluation process does not, by definition, take into account the skills of, and contributions made by, individuals as it evaluates the job and not the person. The job output of employees who are motivated are different to that of those who are not, especially at managerial level and in the case of employees who are called upon to exercise a high degree of skill. This will be all the more so in the case of 'knowledge employees' as the application of knowledge will be a
key to productivity in the advanced key industries of the future. Since in the twenty-first century, the education and skills of the workforce will end up being the dominant competitive weapon, pay systems which do not adequately and fairly compensate performance and skills will have little strategic value. In many enterprises there has been a radical transformation in the managerial skills required and of the role of managers. This transformation needs to be reflected in the rewards offered by compensation systems. These trends are permeating down to lower categories as well. The changes in the managerial role are explained by Peter F. Drucker as follows:

"...during and immediately after World War II, a manager was defined as 'someone who is responsible for the work of subordinates'. A manager, in other words, was a 'boss', and management was rank and power.... But by the early 1950's, the definition had already changed to 'a manager responsible for the performance of people'. Now we know that this also is too narrow a definition. The right definition is 'a manager is responsible for the application and performance of knowledge' ".

Since pay systems linked to a hierarchical system of management do not recognise the performance of incumbents of the jobs, promotion is the main means of rewarding performance and obtaining higher earnings. Even in a traditionally hierarchical organisation the number of positions available for this purpose become less as one progresses upwards in the hierarchy. With organisational structures becoming flatter and less hierarchical, the avenues for promotion are decreasing. The willingness of employees to learn new skills is partly conditioned by the rewards it will bring them. Job security is one of the benefits which can accrue through skills upgrading. Acquisition of new or enhanced skills and improved performance have to be rewarded through compensation systems so that the employee does not need to move to another level in the organisation to benefit financially.
Compensation based on some traditional job evaluation systems tends to lead to managers and supervisors accumulating for themselves as much resources as possible, such as subordinates, irrespective of the need for such resources for effective performance of their jobs. The reason is that the size of their budgets and the number of subordinates reporting to them often have a bearing on the value of the job and, therefore, the level of their pay. Reorganisation of an enterprise can also be difficult where it results in particular jobs being assigned a lower level than before.

Traditional compensation systems are therefore under attack for reasons which can be grouped under three heads. The first is that while providing for internal consistency and equalisation of pay for similar jobs, they are unfair to the extent that they provide little scope for rewarding performance, skills, innovation and creativity. The lack of fairness is especially felt when management staff capture the largest share of the performance gains for reasons related to their position and status rather than to their performance. In such cases employees lower down in the hierarchy do not have the opportunity to share at all, or according to their contribution, in the gains for which they too are responsible. Equity is of course a problem even when performance or skill based pay is introduced and is a critical factor in the success or failure of the system. The second basis for dissatisfaction is that traditional pay systems lack adequate incentives for productivity and quality improvement. The third basis of attack is that innovative pay systems, unlike traditional ones, have the potential to reduce costs of labour while increasing earnings. It has been remarked that "the most important trend in pay determination has actually been the loosening relationship between job assignment and pay level ... they are gradually changing the basis for determining pay from position to performance, from status to contribution." Although this assessment is in relation to the USA, the trends are visible, even though to a lesser degree, in other countries, and are likely to increase during this decade.

D. STRATEGIC CHOICES, PRE-CONDITIONS AND PROBLEMS

Broadly speaking, most strategic pay systems have one or more of the following objectives which represent strategic issues for employers:
(i) To become, or to remain, competitive in terms of labour costs through a compensation system which is sufficiently flexible to adjust to changes in business conditions which, more than ever before, occur rapidly. This involves using "pay to improve organizational effectiveness so that organizations can maintain their present wage rates and still be competitive".  

(ii) To ensure that the enterprise is cost effective by designing wage and salary systems and/or other financial benefits to promote the productivity and profitability of the enterprise.

(iii) To motivate employees by linking pay increases as far as possible to performance, determined by reference to individual or group performance, or the performance of the enterprise as a whole.

(iv) To promote skills development, at all or at particular levels, critical to competitiveness, by linking pay systems to appropriate skills.

(v) To determine pay by reference to the value of the person's performance and skills, and not only of the job, to the enterprise.

(vi) To attract or to retain competent and skilled staff.

(vii) To provide general satisfaction, or to satisfy people's sense of distributive justice which is sometimes achieved when the same criteria are applied to all employees.

(viii) To change organisational culture or to reinforce it e.g. reinforce or change its culture to one of customer satisfaction or quality.

Although there is an increasing interest in performance and skills based pay in the current decade, many employers have failed to effectively link the performance component of earnings to performance. An opinion expressed several years ago that "the weight of empirical evidence strongly suggests a weak relationship, at best, between pay and
performance at any organisational level" ¹³ is probably less true today, but some of the undernoted problems may inhibit the rapid spread of performance pay. Among the pay systems that are likely to increase in popularity are those which link pay to productivity gains as the enterprise in such cases is not committed to the same level of earnings in the future if there is a drop in performance, and pay systems linked to skills. A pay system which is sufficiently flexible to absorb business downturns also has the value of reducing the extent of redundancies and lay-offs in times of crisis. At other times, such a system would result in higher earnings without increasing labour costs, and also establish the link between performance and pay in the minds of employees. Some developments could have a positive impact on the spread of performance pay systems. Sophisticated information systems facilitate quick analysis of data needed to establish performance pay systems, while decentralization of enterprises improves the ability to measure performance and relate pay to performance. More openness, information sharing and consultation in managing enterprises and the tendency to reduce levels of hierarchies could also provide a facilitating environment.

In societies with high standards of living pay as a motivator is a matter of some controversy. Some well known behaviourial scientists in the USA have been interpreted as having regarded pay as a less important motivating factor than intrinsic rewards such as participation and job enrichment, so that performance pay has been seen as a less important tool in strategic human resource management. E.E. Lawler ¹⁴ points out that this does not "imply that the leading figures in the 'human relations' movement do not understand the importance of pay. But, by emphasising other rewards and by not dealing explicitly with the role of pay, they have opened the door for others to interpret their writings as implying that pay is unimportant". Pay has the unique advantage of being a potential to satisfy needs at different levels in the hierarchy of needs. At the lower level it satisfies people's economic needs and provides a sense of security. At the higher level, while economic needs are never completely absent, pay can be seen as a badge of recognition and achievement, and as an indicator of a person's value to the organisation. In many societies it provides the means for employees to obtain the external manifestations of success, be it a luxury car or house, or a luxurious life-style.
It is, of course, obvious that no pay system can link the entire, or even the larger part of, pay to performance. Other needs have to be satisfied such as compensation for increases in the cost of living and a guaranteed level of earnings to ensure a standard of living not dependent on pay fluctuations. Evidence sometimes cited to support the view that pay has little positive effect on performance is often explicable on the basis that the pay in question was determined not on performance criteria but on the individual's training, experience or potential. Therefore "one of the major limits on the effectiveness of pay as an incentive is the ability of management to design compensation programs that create the perception that pay is based upon performance". 15

The principles underlying a compensation system should be influenced by the organization's business strategy and core values 16. Pay strategies should be consistent with an organization's business strategies and should promote them. A mismatch between them will only increase costs and bring no gains to the organization. Similarly, assessments to determine qualification to receive awards should be based on objectives to be achieved by the organization. Whether the organizational objective is quality, quantity, customer satisfaction, market share or profit, it must be communicated to, and be understood by, everybody who may qualify to share in the rewards. These objectives should form the basis on which the pay system is designed and be the goals to be promoted by the pay system.

Pay systems which seek to compensate for performance can be ineffective if the human resource management strategy fails to take account of the fact that pay is one of several motivating factors, and that other needs also must be satisfied. Rewards may be extrinsic or intrinsic. The latter are ones generated as a result of performing the job such as job satisfaction, intellectual stimulation and a sense of achievement, and often satisfy social needs. Extrinsic rewards depend on the evaluation of performance (or skills) by others, and do not automatically result from performing the job. Nor are rewards always monetary. Status, security, personal development, recognition, achievement and even friendships developed in the workplace are rewards. Since a reward should be one which the recipient values, a reward system should contain a mix of monetary and non-monetary rewards. Unless
Pay is a part of a whole human resource management strategy, other factors in the work environment such as lack of communication and conflictual relations can negative the positive effect a pay system may otherwise have on performance. Incentive systems designed on the assumption that performance can be improved largely through a pay system are likely to fail, because in such cases the overall strategy is likely to overlook other critical factors which impact on productivity and performance. For example, training is essential if employees are to perform their jobs effectively, and goal setting is critical because employees must know what is expected of them.

The difficulty of measuring merit may present an obstacle to the development of performance linked pay, especially in respect of categories and operations where measurement yardsticks are difficult to devise. Even where performance measurement is possible, managers are often reluctant to make negative assessments of their subordinates, and an over assessment therefore results. Determining criteria for performance evaluation and measuring performance are the areas over which managers and employees have the most control. Some of the other obstacles discussed below are largely outside the management's control and reduce management's financial capacity to design and implement systems which are sufficiently attractive to achieve their objectives. Pay systems related to performance should not be introduced where performance cannot be measured, unless in such cases rewards are based on the organisation's overall performance. But overall performance may be inequitable by categories whose performance can be measured, unless some part of the compensation is paid to individuals based on their performance or that of the group to which they belong.

Equally important is the need for regular feedback to employees of their performance. It is insufficient to inform them of poor performance only at the time of an annual performance review which determines the pay increases. The whole process should be a part of a cycle in which joint objective setting is followed by performance reviews and compensation, a process which is repeated in the course of the year.
The importance of an appraisal system designed to match the objectives of performance (and skill) based pay cannot be over-emphasised, because appraisal systems can be used for a variety of purposes such as promotion, career development plans, to assess training needs and for purposes of counselling. Some systems are used to determine negative sanctions against employees whom the employer considers poor performers. Using a system designed for purposes of negative sanctions to determine performance pay can be seen as using performance pay for disciplinary purposes and will be counterproductive. Hence the value of a system which is mutually acceptable in terms of both criteria and the process. Setting objectives through a process of two-way communication between supervisor and supervised leads to agreed objectives on the basis of which performance is measured. Therefore an effective performance pay system requires performance to be measured by agreed criteria developed through consultation.

A performance appraisal system appropriate to a pay scheme which emphasises performance can be complicated and costly. A merit pay system cost the Bank of America US dollars 1 million a year for evaluating performance by twenty persons employed for this purpose. Enterprises which cannot afford the expenditure on operating as objective a system as possible have to depend on the supervisors and/or employees for performance measurement. Many of them will invariably be untrained in what is obviously a skill, and the process can be subject to all the prejudices and favouritisms about which one often hears complaints.

Wage increases negotiated with unions through collective bargaining can be an obstacle to the introduction of performance and skill based pay. Once wage increases have been negotiated on criteria which, in collective bargaining, do not include individual performance factors, it usually leaves the employer with little capacity - if any - to grant further increases based on performance. The impact of union negotiated wage increases spills over to non-unionised firms, which often find it necessary to keep up with wage trends. Collectively bargained wage increases also result in pressure for upward revision of salaries of categories not covered by the increases in order to maintain pay differentials. Increases in cost of
living resulting from inflation leading to pay increases similarly reduce the capacity of employers to reward performance through pay. Performance pay systems are therefore easier to operate in times of low inflation.

Pay systems are devised in a context which is conditioned by factors which are both internal and external to the organisation. The following list from one writer is illustrative.

<table>
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<td>To The Enterprise</td>
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<td>Control labour costs</td>
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<td>Equity between the worth of jobs</td>
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<td>Equity in terms of rewarding different contributions</td>
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<tr>
<td>Personnel management policies</td>
<td>Legislation if any, as to payment, equal pay and opportunity</td>
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<td>Technology and organisation of production constraints</td>
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An organization should formulate a compensation philosophy containing, in addition to goals and purposes, features such as a policy to communicate the philosophy; a decision making approach to compensation; determining at what level the organisation wishes to be in the market in terms of pay (high, average or low); the right mix of cash and benefits; the objectives in appraising performance; the relationship between the compensation system and the organisation's philosophy; and how changes will be made to the compensation system.
Flexible pay systems, especially performance linked ones which place at risk a part of an employee's earnings, are generally less acceptable to employees where there is a wide disparity between the pay of management staff and others. Therefore Japan, with its much smaller differentials in pay between managers and other staff when compared with many countries, has found it easier to introduce such systems where a part of earnings is placed at risk.

It is important that an organisation rewards its employees in the manner undertaken. Withholding promised rewards due to financial constraints arising from business downturns is likely to erode trust and result in performance declining. The organisation is not likely to be believed if it seeks to introduce new schemes in the future. Therefore an organisation should ensure the availability of resources to reward performance in the manner undertaken.

Compensation systems should "be integrated with the structure and work culture of the organisation.... If, for example, an organisation has an effective participative work culture, then the reward system should reinforce values and behaviour that encourage staff to participate in decisions and to contribute to their team. A compensation system that emphasised individual accountability for performance outcomes would be inconsistent with such a work culture. Individual bonuses, for example, could undermine employees' willingness to cooperate with other team members and assume responsibility for decisions that are not directly related to their individual job performance." However, deftly handled, strategic pay systems can be used to change behaviour. For instance, if bonus is the reward and the objective is to generate team work rather than individual performance, the reward system could provide for everyone in the team to share equally. Pay systems can have a profound effect on the culture of an organisation. Systems which offer share options to everyone in an organization irrespective of their level in the hierarchy tend to reinforce a culture of egalitarianism, and often one of team work and commitment. Rewards restricted to persons at particular levels in the hierarchy reinforce a culture that is hierarchical and - quite often - bureaucratic in which the system is seen as more important than the people. In creative and know-
ledge - based enterprises a culture of risk taking can be encouraged by a system which rewards it but which does not necessarily punish failures.

Sometimes pay systems may need to motivate core staff whose performance, skills and retention in the enterprise are critical to the organisation's competitiveness. This implies that the system must be sufficiently flexible to meet challenges posed by external events. Thus skills shortages place considerable pressure on reward systems to adapt to these conditions. Again, when there are appreciable changes in market rates, the organisation's pay system should reflect this lest the rewards cease to be effective in meeting their objectives.

It is also important-and this is a central theme in an overall human resource management policy -that the pay system should be perceived as equitable in the sense that it treats in a consistent way people of different levels of skills, responsibility and performance.

In introducing skill and performance based pay and performance measures for this purpose, it is necessary to take into account that performance is the result of both ability and motivation. Therefore expected performance will not result unless both factors co-exist. This has important implications for managements. First, as we have noted earlier, monetary rewards are only one motivating factor, so that if management fails to put in motion other systems within its control which contribute to motivation (or does not remove de-motivating factors from the environment), the performance expected will not result. Second, ability does not consist only of what a person brings to a job on recruitment. It is also conditioned by other factors within the management's control, such as appropriate training. Therefore the success of performance and skill based pay systems also depends on management's willingness to provide the opportunities for self-development. In short, performance based pay should be placed within the context of both a comprehensive human resource management and development strategy and be integrated into the overall strategy of an enterprise.
A compensation system geared to performance or skills should be subject to periodic evaluation by management and employees by matching objectives against the actual outcomes whether they be productivity, reducing staff turnover or promoting team work. Otherwise the organisation may lose sight of the fact that the compensation system is a strategic management tool for the mutual benefit of the enterprise and employees. Therefore the system should be characterised by flexibility in the sense of adaptability to needed change if it is to avoid becoming an end in itself.

The time of payment should be decided in such a way as to maximise the motivating effect. In some cases the nature of the reward would condition the time of awarding it. A holiday package, for instance, cannot be given weekly or monthly. There is considerable value in giving the reward as soon as possible after the 'performance' is completed. Thus according to the President of Nucor Corporation, a successful steel company in the USA, the performance bonus is paid weekly since the company believes that in the employees' minds the payment is then more easily related to their effort. Care should be taken when adding to a job evaluation system based on the job content - a system in which the person, rather than the job, is evaluated to determine pay because, as stated by E.E. Lawler:

"No one has suggested that person-based job evaluation systems should totally replace job-content-based evaluation systems. On the contrary, there is reason to believe that person-based systems are limited in their applicability. Nevertheless, they are proving useful in certain situations, and the decision to encourage them and allow them where appropriate is a key strategic issue in the design of compensation systems".

He identifies staff with technical expertise, as distinct from managerial responsibility, as a category to whom person-based evaluation systems would be most appropriate.
As the Confederation of British Industry points out, none of the strategies relating to flexibility, including pay flexibility, "can be introduced in isolation from factors such as training, continuing development as well as fundamentally changing culture and attitudes. For example, many of the failings of performance-related pay emerging from recent research and evaluations can be traced back to too much haste at the introduction stage, insufficient emphasis on performance management combined with inadequate management training or support for the process. In fact, ensuring performance management links to pay for performance is very much the third stage after embedding objective setting procedures linked to a defined business strategy and performance review.25. The CBI regard the criteria for success of performance related pay as falling within the following four heads:26

(i) Commitment, which involves management also having their rewards judged by the same criteria, linking performance pay to organisational objectives, defining the vision of what success is and establishing a strategy to achieve it.

(ii) A vigorous system which is based on planning, managing, reviewing and rewarding success 27.

(iii) Consistency i.e. equitable treatment of people by maintaining constant reward levels for people performing at the same level.

(iv) Communication to employees about objectives, values, benefits to them and the enterprise from improved performance.

The success of person - based pay systems - especially ones which place at risk some part of earnings because such earnings are variable -depends to a large extent (as does productivity improvement generally) on an industrial relations climate conducive to a willingness to share losses
when there is a downturn in business. Such a climate depends on the encouragement of many features: effective two-way communication and information sharing, employee consultation or involvement in devising formulae and monitoring them, a fair and equitable gain sharing system, communicating the scheme to enhance understanding of it, a climate of cooperation and trust.

Finally, cultural considerations should not be overlooked, where they are relevant. The substantial increase in investment in recent times could raise problems in respect of organizational objectives and pay systems to further them. The investment in Asia, for instance, is from both within and outside the region, and has resulted in many foreign companies or joint ventures operating with local staff. This involves the need for two cultures to agree on common objectives, the process by which this agreement should be reached and on how to achieve the objectives. The difficulty of managing joint ventures, for example, flows from the many compromises which the partners have to make in management decisions, and the different ways of negotiating these compromises that the partners may be used to in their own respective cultures. The underlying assumptions on which decisions are made are important to the workability of the partnership. Even if common objectives can be established, the way of setting about achieving them may again bring into play cultural differences. For example, reward systems geared to individual performance may be seen in some Asian cultures as less appropriate and effective than ones geared to group performance because in such cultures individuals are more comfortable performing in a group rather than as individuals. The fact that in several Asian countries cultural relationships are based on interactions founded on status and between 'unequals' (which may be defined in terms of position, age and sometimes even gender), rather than between equals, may need to be taken into account. Thus:

"Culture is the social energy that drives - or fails to drive - the organization. To ignore culture and move on to something else is to assume, once again, that formal documents, strategies, structures, and reward systems are enough to guide
human behaviour in an organization and that people believe and commit to what they read or are told to do. On the contrary, most of what goes on in an organization is guided by the cultural qualities of shared meaning, hidden assumptions and unwritten rules".  

E. PERFORMANCE CRITERIA CHOICES

In determining performance criteria, an issue which frequently arises is whether the criteria should be individual or team-based performance, or whether it should be related to overall company performance, or be a mixture of them. No answer of general applicability can be given, but there are several considerations which should be taken into account in making the choice. The issue presents enterprises with one of the most important strategic choices in formulating people-based pay systems. In making the choice, it should be borne in mind that performance pay reflects a tendency to move away from assessing performance by reference to personal qualities towards assessing performance by reference to management objectives.

Team based rewards may be an appropriate choice where individual performance is not measurable, or is too difficult to measure, or where the objective is team work and cooperation. As we shall see, the distribution of bonuses under Japanese productivity gain sharing systems is based on both individual and team performance, depending on the circumstances. Team-based criteria would have a positive effect on team work. But "when the perceived earnings risk is high, team based rewards can lead to conflicts, reduced commitment to the team effort, and even withdrawal from the team by individual members. In these circumstances, a lack of perceived control is the main contributor to employees' perceptions of a high earnings risk". Individual performance criteria, so long as they are supported by an appropriate performance appraisal system, have the value of motivating employees through placing them in control over their own performance. But they could also have the negative effect of depriving the individual of a motivation or incentive to cooperate. This consequence
could be quite adverse when - especially in knowledge-based enterprises - overall performance and productivity depend on team work and cooperation, and on sharing knowledge and information. One solution is to link only a part of the reward to individual performance and the balance to group or organisation performance. On the other hand, when rewards are linked to the performance of the enterprise as a whole, employees may find it difficult to identify their own contribution, especially at non-executive level. Where management's performance has been poor, employees are likely to feel that their performance has been good and that the enterprise's poor performance has been due to factors outside their control but within the management's control.

Performance criteria related to group rather than to individual performance designed to foster cooperation, team work and a productivity culture are unlikely to achieve these objectives unless the corporate culture in other respects promotes these values, which will otherwise be a deviant culture within an organisation whose culture is something else. Therefore the objectives should be seen as values permeating the organisation as a whole. For example, it is pointless to seek productivity improvement through a performance pay system if the management culture as a whole is inimical to productivity improvement. It is management's responsibility to integrate into the corporate culture the ingredients needed to build a productivity culture, and to promote change, innovation, cooperation and quality. "Successful managers are those who work to define and create the type of corporate culture that breeds productivity." 30.

Where the goal is to increase individual productivity, management would have to take steps to satisfy some of the basic needs of individual productivity. The first of these is job knowledge for which training or retraining may be essential because "training makes up the difference between abilities needed on the job and abilities brought to the job. It is important for the manager to realise that job knowledge is a combination of prior abilities and developed aptitude" 31. The second is rewards. The third is performance goals, in which the crucial elements are clarity of goals (so that the individual knows what is expected of him) and goal identification (so that each has a stake in the success of the group). The fourth is feedback on performance, essential to motivation and performance improvement.
The many choices available in person-based pay are such that it has been aptly observed that "managing post-entrepreneurial pay is one of the ultimate corporate balancing acts". Rosabeth Moss Kanter identifies the following key strategic choices:

(i) **Rewarding either individual or group contributions.**

(ii) **Rewarding on the basis of the performance of the organisation as a whole or that of the unit.**

(iii) **Distribution of rewards controlled by management and therefore discretionary or subjective or both, as distinct from automatic entitlement on the satisfaction of the conditions.**

(iv) **Rewards determined relative to base pay or decided by reference to the value of the contribution to the organisation.**

(v) **A single system of rewards for the whole company or several systems.**

Where the performance criteria relate to the performance of the enterprise, the latter has usually been measured in terms of financial performance (or as in Japan, also in terms of market share gained). Though the 'bottom line' is indeed the last figure in the balance sheet, other factors are now being given greater weightage than before - factors which contribute to the overall performance of the organisation. For instance, short-term financial criteria may present an incomplete picture if the orientation is customer satisfaction which in the long-term is what produces the financial results. This change is taking place in the USA, for instance, where there has been extreme investor pressure for maximum returns on investment in the short-term. An illustrative example referred to by one writer is a company the earnings of which per share had been the highest priority. In its new list of priorities in order of importance were: customer satisfaction, cash flow, manufacturing effectiveness and innovation. In some countries, notably in Japan and some European ones, the roles and respon-
sibilities of companies in society have traditionally also played an important part in determining priorities.

Two important principles are worth noting. One is that the performance criteria and the evaluation must be perceived by employees as being objective and also as being within their control. Second, the beneficiary of a reward system should consider the benefit received as being a sufficient reward for the effort or performance it is intended to compensate. Rewards seen as insignificant as compared with the achievement are likely to be stigmatised as inequitable.

Other aspects of performance criteria will be referred to again in the section titled "Conclusions".

**F. TYPES OF PERFORMANCE BASED PAY**

The practices in enterprises, especially in the USA, reflect a myriad schemes. Referred to below are a few types, some of which have been in existence for some time, and which encompass some of the schemes in operation other than those linked to skills and knowledge. It has been found that despite the advantages of group incentives, they are the least common wage system in market economies, rarely covering more than 20 per cent of employees, and they increased only marginally in the 1980's. On the evidence concerning the relationship between productivity and profit-sharing schemes, the OECD has concluded:

"One particularly broad survey of the evidence from a variety of sources, including econometric studies, case studies, opinion polls, and comparisons between capitalist and socialist economies, concludes that the mean effect of profit sharing is to raise productivity by 7.4 per cent. (The median effect is 4.4 per cent). The outcomes of individual studies vary substantially around this average. On the other hand, the positive relation-
ship between profit sharing and productivity appears to be even stronger in organizations with worker participation arrangements".

**Merit Pay**

Payments granted as salary increases (or increments) for performance are absorbed into the base salary and are not lost to the employee on account of poor performance in the future. This constitutes one of the criticisms often directed at merit pay increases. Sometimes the salary system, in addition to the basic pay, may contain two elements. The first may be a cost of living adjustment on account of inflation granted to all. Such increases may be in the form of an allowance based on indexation or may be an increase in the basic salary. Either form may be the result of collective bargaining in the case of non-executive grades. The merit increase represents the second component conditioned by the level of the employee's performance. It could represent a fixed amount or a percentage of the basic salary which may vary with the level of performance. This is different to fixed annual increments granted to everyone, which reflect seniority, not performance. Merit pay in one form or another is probably in operation in most enterprises in many countries, and therefore represents the commonest form of paying for performance.

Merit pay increases as a percentage of base pay perpetuate the job-position criteria of traditional systems, and has also been criticised on the ground that the amounts are often too small in times of inflation. Hence the provision sometimes for a cost of living compensation factor, but in that event the amount available for merit increases may shrink in the context of the limitations on the total resources available for distribution on account of pay.

Individual merit pay dependent on evaluation of performance by supervisors sometimes results in supervisors failing to make objective assessments. They may not wish to displease their subordinates - a frequent management problem. Over-rating is indulged in also to boost the supervisor's own performance lest poor ratings are interpreted as a reflection of his inability to manage. Besides:
"The premise of many merit pay systems is that the individual component of joint output can be singled out. And this can put the group members against one another in competition for scarce resources" 39.

As in the case of incentive pay, merit pay is difficult to operate in relation to work in knowledge and technology based enterprises. In many such organizations not only is individual performance difficult to measure, but what is needed is team and group orientation to solve complex problems, employee involvement and, generally, inter-dependence.

One of the demotivating practices in merit pay (and gain-sharing) systems - especially in the USA - is the considerably larger increases management staff receive compared to categories below them, even if others have contributed to the company and the distinction in quantum is not warranted by differences in contribution. This practice only tends to perpetuate the job or status associated with pay which is already reflected in the base salary and benefits, and deprives the system of the equity needed to make it effective.

**Incentive Payments**

Incentive payments may take the form of once-and-for-all lump sum payments which have to be earned during each payment period by good performance. They are not added to basic pay. The frequency of the payment may vary e.g. annually, quarterly or monthly. Sales commissions are a traditional form of incentive pay, but could have less to do with performance because sales may be determined by factors other than the salesmen's performance e.g. product quality, price, brand name. Unlike in the case of performance bonuses, it is a characteristic of incentive payment schemes that the employee knows beforehand the formula on which payment will be made and the relationship between performance and the payment. Further, in schemes such as sales commissions there is less reliance on a supervisor's appraisal to determine the level of rewards because the performance criterion (volume of sales) is statistically available.
Another traditional incentive payment scheme linked to performance is the piece-rate system which is related to output. When the payment is not related to the time taken to complete the work, it is less related to performance. When the payment is related to a given output completed within a specified time-frame, it is more conducive to higher production. Incentive and piece-rate pay systems geared to normal or standard outputs suffer from several drawbacks. They often create conflict in three situations. Not infrequently employees seek to lower the standard beyond which the payment should commence, thus leading to conflict between employees and management. The conflict occurs again when the standard norm has to be revised due to reasons such as technological change or new work processes and work re-organization. Where the employees succeed, it negates the value of the system to the employer and increases costs. The recipients sometimes have to depend for their work output on other categories of employees who are not part of the scheme. This may result in conflict between the recipients and non-recipients. Therefore incentive systems tend to be divisive as between management and employees and among employees themselves. This type of pay system often discourages employees from developing more productive work methods, etc. lest the standard norm is increased by the management. Frequent changes in products and technology require frequent changes in the incentive pay system. Apart from continuing the cycle of conflict, frequent changes are costly. Finally, incentive systems are more appropriate to measurable repetitive tasks, which is the environment in which they were developed. They are not capable of application in high technology and knowledge-based enterprises as well as in parts of the service sector, which require information sharing, problem-solving, team-work and the operation of complex machinery. Incentive pay systems continue to have some relevance in organisations engaged in high-volume, low-skilled manufacturing activities, and in some basic service work, where there can be few intrinsic rewards in performing the job.

Payment by results systems have been more common in centrally planned economies where it has been the main wage payment
system, than in industrialized market economies, but it has declined in importance since the 1960's in both types of economies⁴¹.

**Bonus Payments**

The type of bonus payments considered here differ from the bonuses which are common in some countries and which are paid for reasons unconnected with performance. Such other types of bonus include ones paid on account of a religious festival, or bonuses which have become 'customary' payments in the enterprise or industry or region, or ones which are simply a payment of an extra month's salary for twelve months' work. Some such bonuses may be related to profit in the sense that they are payable only in a profitable year, or they may not be dependent on profit. Where a bonus depends on profit or it is based on a formula related to profits, it comes nearer to performance pay based on the company's overall performance measured in terms of profit only. In the case of such payments the individual is less likely to see the link between his performance and such payments.

Performance based bonuses (like all types of bonus) do not form a part of the basic salary and have to be earned during the performance period. Performance bonuses should be based on performance appraisal ratings. The basis on which the distribution is made may not be known in advance, and would depend on the total amount available for distribution. A system which pre-determines the quantum of the bonus for each performance level would indicate to employees the potential for earning it.

The bonus which an individual receives may be based on individual performance, or on that of a group (department, section, work team) or on that of the enterprise as a whole. Bonus based on an individual's performance is possible only where individual performance can be assessed on objective criteria. But group bonuses would be more appropriate where the individual's performance is closely tied to the performance of others. Even in teams the performance or non performance of particular individuals could be critical. It is possible to combine individual, team based and corporate performance measures.
In the USA since the mid-1980's there has been a substantial increase in the number of union agreements which have substituted one-time bonus payments for the traditional wage increases. The idea of salary increases tied to company performance has also been promoted by some economists. It is estimated that performance incentive bonuses are paid to executives in about 97% of large and 86% of medium sized companies in the USA, in about 70% of companies in Western Europe and in about 66% of companies in Singapore. As a percentage of base pay of executive staff, incentive bonuses represent (depending on the managerial level) 36-68% in the USA, 23-27% in the UK, 17-27% in Germany, 16-31% in France, 5-10% in Japan, 15-19% in Malaysia and 12-17% in Singapore.

Gain-sharing

Gainsharing differs from profit sharing in that "it combines a bonus plan with a participative approach to management... (and) it typically measures controllable costs or units of outputs, not profits". As Japan has demonstrated, basic to successful productivity movements is the sharing with employees of the productivity gains by linking earnings with productivity to achieve "such multiple goals as improving labour productivity, upgrading employees' living standards, strengthening commitment of employees, advancing labour management relations, securing flexibility in labour costs, and maintaining corporate viability". In recent years the significant criteria for wage increases have been corporate performance (43% of unionised enterprises consider this the most important), the average increase consequent upon previous negotiations, and the labour market situation. Inasmuch as the indicators of corporate performance (productivity and profitability) provide an approximate idea of overall performance, a part of the productivity gains is shared between the company and the employees through collective bargaining. One of the advantages of the Japanese gainsharing system has been from a competitive point of view. The system of bonuses makes pay costs far more variable than in other industrialized countries. In addition, it reduces the incidence of redundancy during business downturns.
In recent years productivity and profits (corporate performance) have been closely related to a part of the pay increases. The Japan Federation of Employers’ Associations (NIKKEIREN) has, over the last few years, promoted in Japan the institutionalisation of productivity-linked pay systems through its programme Productivity Standard Principle and the Ability to Pay. It also has, since the late 1980's, conducted several programmes for employers' organisations in Asia to popularise this concept. This principle means that the average national wage increase rate should be kept close to the real rate of increase in national labour productivity, and any wage increases which exceed the level of productivity will result in higher inflation and adversely affect not only stable economic growth but also economic management. But this productivity standard principle applies to wage fixation from a macro point of view. At enterprise level, while the national economic trend should be borne in mind, wage increases should also be conditioned by the enterprise's ability to pay consistent with its short and medium range management plans relating to sales growth, capital accumulation and return on investments.

For productivity gain-sharing purposes collective bargaining in Japan is supplemented by Joint Consultation systems:

"The two arrangements of the collective bargaining and the joint consultation distributed about thirty-five per cent of the total value added at the establishments that have more than four employees in manufacturing industry. The labour share has been stable for these fifteen years. This suggests that the gain sharing machinery is well established and that the management and the labour commonly share the criterion for pay increases."

In the Japanese system there is a close link between pay, productivity and profits. Bonus, which is the pay component linked to productivity, is a payment common in most Japanese enterprises. The bonus element usually represents 3-5 months' pay. The quantum of the
bonus is decided in some enterprises through the collective bargaining process and in others through the mechanism of joint consultation. Some enterprises have formulae which combine productivity and merit rating. For example, a firm may decide on a quantum to be distributed as a bonus. One part of the bonus may be paid as a fixed amount to guarantee a fixed income. The other part may be linked to productivity, but in the distribution each employee would receive a merit rating. This type of formula is not arrived at unilaterally but through joint consultation and is subject to annual review. It is estimated that about one third of companies employing 30 or more people have productivity-linked bonus formulae. The distribution may be direct to individuals, or first to the department or unit, the purpose of the latter procedure being to take account of different performance levels of each section. Shozo Inoue, on an analysis of gain-sharing figures which indicate a close relationship between bonus and enterprise growth, concludes that they "imply that employers and employees grow and improve together".

It is an important feature of Japanese gain sharing systems that employees participate in the formulation and monitoring of the formulae. This enables employees to understand and accept downturns and upswings in business cycles and to take a long term view of growth. It also facilitates motivating them to contribute to overall enterprise performance by providing opportunities for them to influence schemes. Such participation fosters a common understanding between management and employees of several issues important to the success of gain-sharing, which are identified by Shozo Inoue as follows:

"(i) Concepts and measurements of productivity.

(ii) Relationships between productivity and pay in general.

(iii) Trends of the past productivity indices and pay at their company.

(iv) Estimates of labour costs and share."
(v) Targets and means of productivity improvements.

(vi) Appraisals of the working of the productivity gainsharing system".

Gain-sharing systems of various types are also found in some enterprises in the USA. A well-known scheme is the one at General Motors' Saturn plant where, in an agreement with the union, the salary which was about 80% of union rates was supplemented by productivity bonuses. Successful gain-sharing schemes usually have two important features. One is the recognition of group over individual performance. The second is criteria for distribution which are objective and capable of measurement in order that employees are able to relate what is paid to the criteria. Studies in the USA have estimated 5 to 15 per cent productivity improvement in the first year in organisations where the system has been successful, and the success depended very much on the human resource management approach in a company 50.

Gainsharing has been practised in the USA for over 50 years, originating in small companies and spreading to larger ones, including service organisations. There are probably over a thousand enterprises practising gainsharing, and it is increasing in popularity 51 for the following reasons identified by E.E. Lawler 52:

"... gainsharing plans are more than just incentive plans; they are an organizational development technology... they are based on a participative approach to management and are often used as a way to install or reinforce other participative management practices. Thus they are in tune with two increasingly popular management trends: pay for performance and employee involvement".
The relevance of participation lies in the need for "a combination of people working...... more effectively together, sharing their ideas, and working smarter. This often requires a formal participative system that converts the motivation to improve performance into changes in the operating procedures of an organization. In the absence of new systems to accomplish these changes, they rarely occur". Some of the common results which have emerged from research in the USA into gainsharing systems are:

(i) Coordination, team work and knowledge sharing are improved at lower levels.

(ii) Social needs are satisfied through participatory and mutually reinforcing group behaviour.

(iii) The thrust becomes cost saving, not how much is produced.

(iv) Acceptance of changes consequent upon technology, market and other changes is facilitated since better performance results in larger bonuses.

(v) Employees come to expect better management and planning as they too stand to benefit therefrom.

(vi) Employees are prepared to contribute ideas to improve performance.

(vii) When unions support gainsharing they are strengthened in view of the higher earnings and better work situation engendered.

Many factors facilitate or impede gainsharing plans. Smaller organizations are more suitable for such schemes because it is easier to see in them the connection between performance and pay. Where measurement is difficult, or where supervisors are not amenable to ideas from employees as to how work can be better performed, gainsharing is less
successful. It is important that the bonus is one which employees can influence through their behaviour. The plan should ensure that in the process of reducing or stabilizing labour costs, other costs do not increase, and quality or customer satisfaction are not adversely affected. Payment as soon as possible after the performance is completed contributes to the effectiveness of gainsharing.

Profit Sharing

One of the oldest forms of sharing the benefits derived from good corporate performance is profit sharing, which has assumed numerous forms. It has been estimated that by 1983 the number of employees in the USA covered by profit sharing schemes excluding the small business sector, and in particular in manufacturing enterprises, was 13% among production employees. The figures for technical and clerical employees was 22%, and for professional and administrative staff 20 per cent. It is also estimated that by 1988 about half a million American firms were operating profit sharing schemes of one form or another.

Profit sharing in companies in the USA does not imply that cash is paid out in every case. In many instances the profit-sharing plans involve the share distribution being paid into an account to which the employee has access, with some exceptions, only on cessation of employment. Thus an empirical study conducted among members of an association of small businesses - the National Federation of Independent Businesses - and among members of the Profit-Sharing Council of America, indicated that 69% of the former and 85% of the latter operated deferred plans rather than cash plans. In many such cases the companies do not have a pension plan for non-supervisory employees, so that the profit-sharing plan is in effect a pension plan.

In arguing in favour of profit sharing as the most appropriate reward system, G. Bennett Stewart III presents the following view:

"Company stock, however, is not the best approach to instilling ownership, for it frequently
leaves too loose a link between pay and performance. The best approach often is to carve employees into a share of the profit contributed by their part of the company. Profit should be defined in relevant cash-flow terms after covering the cost of all capital employed, a measure that Stern Stewart & Co. calls Economic Value Added. EVA provides employees with three clear incentives: to improve profitability, to grow profitability, and to withdraw resources from uneconomic activities. In addition, it ties their decisions and energies directly to the 'net present value' of their enterprise ...... 50 prominent companies ... have adopted this approach in recent years".

Long Term Incentives

Especially at executive level in the USA, long term incentive plans have been developed to retain and motivate managerial staff, to reward performance and to reduce fixed costs. In this respect a wide gap exists between practices in enterprises in America and in other countries. Such schemes for executives operate (varying from medium to large enterprises) in 64-92% of companies in the USA, 19% in Germany and France, 27% in Britain and 9% in Singapore. They include schemes such as:

(i) Share option plans which provide rights to purchase shares at a fixed price for a defined period with a view to promoting convergence of the interests of share-holders and executives..

(ii) Bonus based on performance over a long period of time (3-5 years) so as to direct attention to long term goals.

(iii) Share grants with restrictions on voting rights, said to be on the increase in the USA.
(iv) Phantom stock, which is similar to (iii) but without using actual shares.

As at 1988, 91% of firms listed on Japan's stock exchange markets had employee stock ownership plans (ESOP), with about half the labour force participating in such plans. The following are differences in the applicability of American and Japanese ESOP plans:

(i) The percentage of firms operating ESOPs in Japan is higher than in the USA.

(ii) Average stock ownership value per employee was about US Dollars 14,000 in Japan and about 13,000 in the USA.

(iii) American ESOPs invariably include executive staff and often exclude non-executive staff, while in Japan executives are excluded.

(iv) While Japan has had little abandonment of ESOPs, the termination rate for American plans was 15% between 1979 and 1985, and 30% during the period 1981-87.

(v) The total value of U.S. ESOPs is less than 3% of the market value of all public companies, and in Japan the figure is 0.85%.

It would be difficult to assess when financial participation schemes are likely to impact positively on performance. Perhaps ESOPs are a contributory factor, but their positive effect is more likely where they exist in an environment of employee participation in decision making.
G. PAY FOR SKILLS AND KNOWLEDGE

Skill Based Pay

Many industrialised countries are, to use Peter Drucker's phrase, entering, or have entered, the age of the "post-capitalist society" in which the application of knowledge determines their competitiveness and performance.² As Michael Porter has pointed out in his many writings, globalisation and technological change have rendered traditional methods of assessing comparative advantage (labour and raw material costs) less significant. Critical is the capacity to innovate and to develop clusters of competitive enterprises in particular industries. In most developing countries the main thrust is export-oriented manufacturing, but their development depends on their ability to move up from low-wage to higher technology manufacturing. Some developing countries which are close to becoming developed ones are seeking entry into the post-capitalist society. In manufacturing, the knowledge-based worker is most productive when he is prepared and able to learn the next higher skill, until he absorbs the important ones, namely, analytical and inter-personal skills.

Whether in the post-capitalist societies or in developing countries which have moved beyond low wage cost manufacturing, two of the most critical factors for enterprise and national competitiveness are the knowledge and skills of employees, in whose skills development the employer has a much greater vested interest than ever before. Among the important trends in skills training is that training is not only for current competence, but also for the purpose of preparing the employee for the next stage of skills he would need to possess. The total skills package which is increasingly needed consists of cognitive skills, interpersonal and communication skills, work attitudes and quality consciousness. In these circumstances another pay system which has developed is linked to knowledge and skills, and such systems are likely to proliferate in the future since knowledge and skills will be among the most critical competitive weapons of the future.
Broadly speaking, the objectives and benefits of skills-based pay systems include the following:

(i) Raising the skills base and versatility of the employees, or of a critical group of employees.

(ii) Increasing flexibility through the development of a multi-skilled workforce e.g. through transfers to cover shortages, reducing idle time when machines break down.

(iii) Operating with a leaner (reduced) workforce.

(iv) Direct connection between new skills and pay increases, reflected in higher pay without increased costs.

(v) Lower turnover of staff and higher motivation through higher pay, job satisfaction and career progression.

(vi) Less reliance on subjective appraisals and more reliance on objective measurable criteria to judge performance.

(vii) Contributing to enterprise competitiveness, and job or employment security.

(viii) Since skills based pay requires a structured training programme, it is easier to plan the career development of employees. Training itself ceases to be ad hoc and unplanned, and is likely to have clear objectives.

Introduction of skill-based pay should be preceded by an identification of the skills blocks to be covered by the pay system, as well as an evaluation of the skills and tasks needed to perform the jobs which are to be covered by the skill based pay. Thereafter these skills blocks have to
be divided into levels having regard to the different skills standards, identifying the upward skills route or progression available to an employee. Employees should be provided with an opportunity to master the higher or different skills through training, which could be company-based training or outside the company or a combination of both. Wage or salary rates would be fixed for each level of skills.

Skill based pay would compensate for three types of skills. One is vertical skills which are the skills exercised by persons above the individual concerned. Learning vertical skills facilitates more participative management, reduces the extent of supervision needed of the individual concerned, and affords him more control in the planning and implementation of his own work. The second is horizontal skills, the acquisition of which facilitates job rotation, the utilisation of staff to fill in for others (e.g. due to absenteeism) and makes it possible to even find work for individuals who may otherwise become redundant. It also facilitates more efficient performance of work as a whole, especially in production processes which call for team effort and uninterrupted services to customers when, for instance, the particular individual with the core skill or knowledge is unavailable. Horizontal skills also provide the individual with a better perspective of the operations as a whole. The third is depth skills which involve, especially in high technology jobs and organisations, the acquisition of a high level of skills in specialised areas relating to the same job. These types of skills provide opportunities for the individual to increase earnings while remaining in the same job, without the necessity to depend entirely on upward mobility to enhance earnings. It also increases his 'trainability' when skills requirements change.

As in the case of other non-traditional pay systems, successful implementation of skill-based pay depends on the existence of certain conditions, some of which have been described by Robert Wood as follows:

"organisations that have successful skill based pay systems are typically committed to the training and development of employees, value per-
sonal growth and encourage employees to adopt a learning orientation in their work. The values and work practices of organisations with strong bureaucratic hierarchies and traditional pay structures are less compatible with skill based pay. The effective introduction of a skill based pay scheme into a bureaucratic setting would require the support of other culture change programmes and would have to overcome some transitional problems.

Like many other innovative management tools, skill based pay requires the appropriate organisation culture if it is to bring gains to both the employer and employees.

Again like any system, skill based pay has many advantages but is also beset with numerous problems. Among its advantages is the fact that it does not lead to competition among individuals to capture a share of what is often, in performance based pay, limited resources available for distribution as rewards. In skill based pay the rewards flow from the multi-skills, so to speak, achieved by the individual. The fact that others achieve the same level of skills does not reduce the opportunity for employees to increase their earnings through similar skills acquisition. In performance pay the rewards depend on the performance of an individual or group in relation to others.

Skill based pay provides an incentive to employees for self-development which, in turn, affords the enterprise the opportunity to allocate human resources in a flexible manner. The ability to move people between jobs or skills can, as many enterprises have found, substantially enhance productivity through effective use of human resources, and sometimes results in the need for less staff. From the employee's point of view it furnishes opportunities for higher earnings and job enrichment, reduces the chances of redundancy and helps to break down narrow job classifications. Horizontal skills acquisition has been found in some enterprises to reduce both absenteeism and staff turnover. The development of skills
encouraged by skills based pay can result in employees being more innovative and being able to participate in problem solving. Further:

"...skill-based pay is an important reinforcer of a participative culture. It is a concrete way that organizations can back up their commitment to participative management.... It delivers a tangible reward to individuals for doing just what the organization says it believes they can do: grow, learn, and develop. Because of this, organizations that have skill-based pay typically have cultures that value human development and are optimistic about the capability and potential of the people who work there".  

When employees reach the maximum level of skills they can attain with no further scope for enhancement of earnings, the employee may have to depend on other factors such as job satisfaction, promotion (though everyone cannot aspire to upward mobility irrespective of vacancies), revision of earnings not related to skills and on other innovations which may be devised by the employer. In referring to the problems associated with skills based pay, one study pointed out that "employee aspirations may not match company needs, which can create some dissatisfaction. And many systems may have a finite life, creating the dual problems of further developing employees who have reached the ceiling of available skills training, and how to evolve the pay system once the original objectives have been achieved". Skill based pay systems require careful planning in regard to the skills to be acquired by each individual, the time frame within which they should be acquired and the length of time during which the acquired skill should be used before moving on to new skills. Skills acquired need to be put to productive use before an individual moves into other skills areas. The mere acquisition of skills should not be perceived by employees as the objective. Therefore some schemes make a percentage of the pay for skills dependent on performance. There should also be a suitable system to certify whether the employee has acquired the requisite standard of skills.
Skill based pay systems involve three other important issues. One is the establishment of pay rates for the skills, acceptable to both the employer and employee. Where employees are unionised these rates would have to be negotiated. In so doing, criteria such as market rates (if any), the value of the reward to the employee as an incentive and to the employer from the point of view of productivity, would be relevant inputs. The second issue relates to situations where particular skills become obsolete and the question arises whether such skills should continue to be paid for. In such instances re-training may be one feasible alternative to redundancy. A third issue is associated with the sometimes high costs resulting from the skill based pay system and the training needed to enhance skills. The costs of training would in today's context need to be treated as a part of overall training costs enterprises have to incur if they are to increase productivity and quality and remain competitive. Many companies in the USA have estimated savings of 30-50% on the unit costs of products as a result of introducing systems to reward skills, and such savings furnish the capacity to meet the extra costs of implementing the schemes. 'Multi-skilling' of staff usually enables the employer to eliminate some costly jobs, usually of a supervisory nature.

Paying for Ideas

Where enterprises and individuals working in them are responsible for inventions and new products, and where creative ideas lead to new business lines, apart from the problem of patents (which is outside the scope of this discussion) the question has arisen in regard to the appropriate reward systems to compensate employees responsible for them. In relation to this issue, a variety of arguments have been advanced to justify rewards which are relatively small considering the benefit derived by the employer. It has been suggested that inventors use the resources of the organisation; that often no single individual is entirely responsible for an idea; that large rewards for ideas could lead to secrecy among individuals. In some instances the small rewards considered in relation to the value of contracts received by the employer have led to legal suits.
One of the more generous reward systems in the USA has been at Lockheed, where the reward system for inventors was 500 dollars when a patent application is filed, 1000 dollars when a patent is issued, 20% on the first 100,000 dollars in returns, 10% on the next 400,000 dollars and 5% on return thereafter. The push for incentives and entrepreneurial rewards, particularly in high technology companies, results from the fact that the individuals affected belong to the category of what Robert Reich calls the "symbolic analysts". He describes them as follows:

"Symbolic analysts solve, identify, and broker problems by manipulating symbols. They simplify reality into abstract images that can be rearranged, juggled, experimented with, communicated to other specialists, and then, eventually, transformed back into reality. The manipulations are done with analytic tools, sharpened by experience. The tools may be mathematical algorithms, legal arguments, financial gimmicks, scientific principles, psychological insights about how to persuade or to amuse, systems of induction or deduction, or any other set of techniques for doing conceptual puzzles.

"Some of these manipulations reveal how to more efficiently deploy resources or shift financial assets, or otherwise save time and energy. Other manipulations yield new inventions - technological marvels, innovative legal arguments, new advertising ploys for convincing people that certain amusements have become life necessities. Still other manipulations - of sounds, words, pictures - serve to entertain their recipients, or cause them to reflect more deeply on their lives or on the human condition. Others grab money from people too slow or naive to protect themselves by manipulating in response."
The innovative individuals represent the core of the organisation, because they are the sum total of the organisation's brainpower, which translates human ideas and imagination into concrete and tangible products or services. Losing them could mean losing the organisation. They have the option of leaving the company and setting up their own organisations. Increasingly such persons tend to regard themselves not as employees but as partners entitled to be treated as such. Thus there are examples in the USA of store managers being offered partnership schemes involving equal sharing of results. Based on studies done Rosabeth Moss Kanter states:

"... across high-tech competitors, special incentives and other entrepreneurial forms of compensation tend to be more widely used by the most financially successful firms. One study of sixty-six companies compared with the twenty-four 'best' companies in terms of financial results with the other forty-two (a five-year average increase in net profit of 9.4 per cent for the 'best', compared with an average loss of 5.9 per cent for the others). The better companies were much more likely to tie rewards to frequently communicated priorities. One common financial award programme involved pools of money provided to senior managers to recognise employees for significant contributions to the organisation, with substantial publicity. (Interestingly, the 'best' were also more likely to use team or group incentives along with individual ones, acknowledging joint contributions to outcomes)"

Stock options and grants are other rewards found in many high tech companies in the USA.
In the knowledge-based companies, paying for ideas will probably become an increasing concern of pay systems, simply because knowledge (and its application) will determine their competitiveness. As expressed by Ikujiro Nonaka:

"In an economy where the only certainty is uncertainty, the one sure source of lasting competitive advantage is knowledge. When markets shift, technologies proliferate, competitors multiply, and products become obsolete almost overnight, successful companies are those that consistently create new knowledge, disseminate it widely throughout the organisation, and quickly embody it in new technologies and products. These activities define the 'knowledge-creating' company, whose business is continuous innovation".

Effect on Hierarchies

Many innovative compensation systems - particularly ones linked to innovation, creativity and the spirit of entrepreneurship rather than the earlier analyzed performance based pay systems - threaten the hierarchies in organisations. There is evidence in the USA, for example, that subordinates sometimes earn under various schemes more than their superiors. Bureaucratic organisations are therefore not likely to introduce innovative pay systems - they will never be innovative or creative in the first place, nor be at the cutting edge of knowledge. There are many organizations which, through their reward systems, seek to reduce differences based on status. Thus Digital (in the U.S.A.) operates a system which is against benefits being available on the basis of hierarchical level. Many Japanese reward systems are based on the same premise. The impact on hierarchy is pithily expressed by Rosabeth Moss Kanter:

"The structure of hierarchy is indeed challenged by post entrepreneurial pay systems, whatever
form they may take. Social psychologists have shown that the maintenance of an authority relationship depends on a degree of inequality. If the distance between boss and subordinate - social, economic, or otherwise - declines, so does automatic deference and respect. The key word here is 'automatic'. Bosses can still gain respect by their competence, their treatment of subordinates, or their help. But power in the relationship has shifted. The situations are more equalised".

If this is so, it is relevant to inquire how in Asian societies, many of which are hierarchical, enterprises have contributed so much to growth. The above observations should be understood in relation to post-industrial societies. As Asian economies move into the post-industrial age, they may find similar strains on hierarchies, with differences being ones of degree, unless the culture in a particular society proves to be stronger.

Pay systems can be designed to either reinforce hierarchies or to have an integrative effect. Attaching more rewards to higher levels in an organization emphasizes, in the eyes of the subordinates, the superior position of each level. Reward systems impact on the structure of an organization and, therefore, should be designed to fit the structure desired:

"The right fit between structure and reward can be found not in a single reward system practice or set of practices but in targeting the reward system to the kind of organizational structure and practices that are desirable from a strategic point of view .... if the strategy calls for an integrated organization with everyone focusing on common objectives, a common reward system is needed. If the organizational strategy depends upon very decentralized units maximizing their own performance effectiveness, each unit needs its own reward system". [76]
H. SOME COUNTRY TRENDS

Singapore

In the early 1980's Singapore's pay system in the private sector was largely seniority based, and consisted of salary scales or ranges with incremental scales. With the economic downturn in 1985 the desirability of reforming the wage system was recognised. In time a flexible wage system was introduced in many private sector enterprises based on profitability, productivity or a combination of both. The profitability model consisted of a service increment and a bonus determined by profit. In the productivity model the total wage increase, which lags behind productivity growth, minus the service increment represented the variable payment, paid annually or bi-annually. In a survey conducted by the Singapore National Employers' Federation (SNEF) in 1990 it was revealed that 42.9% of employers surveyed adopted the profitability model, 6.5% the productivity model and 41.8% a combination of the two. The productivity yardstick was the national productivity growth figure. Since Singapore's growth between 1988 and 1991 averaged 8.8% per year, the scheme has yet to be tested at a time of economic downturn.

In addition to performance-related pay schemes which formed a part of an enterprise's annual wage determination process, other performance-related pay schemes have been surveyed and published by the Singapore National Employers' Federation. The report covered individual incentive plans, group productivity plans, profit-sharing schemes, employee share option plans and case studies. The main highlights of the survey were:

(i) Of the 660 companies surveyed, 29.4% had some form of performance related pay scheme, and 15.5% indicated their desire to introduce such schemes.

(ii) The commonest schemes were individual incentive plans (62.9%), but 24.2% operated more than one type of scheme.
(iii) Many of the schemes had more than one objective, the main one being to increase employees' output. The next commonest objectives were to link pay and individual effort, to link pay and company performance, to encourage work improvement, and to reduce the need for supervision. About 74.2% claimed that their plans were successful when measured against the objectives, 1.2% said they were unsuccessful and the rest that they were unable to evaluate due to the short duration of the scheme at that point of time.

(iv) 66.9% reviewed their schemes annually, while others reviewed them when the need to do so was felt.

(v) In about 38% of the companies with performance related pay schemes at least 75% of their full-time employees participated.

(vi) In about 35.2% of the companies all categories of employees participated, while 31.6% covered non-executives only.

(vii) 55.3% of the schemes covered all the divisions of the company.

(viii) Payment under the schemes was monthly in the case of 52.6% and annually in 25.2% of the cases, the balance being half yearly, quarterly or fortnightly.

(ix) In more than half the companies the schemes had resulted in at least a 10% increase in the basic pay.

(x) The pre-conditions identified by the companies for success were: simple and realistic plan (76.4%); mutual trust and understanding (51.2%); achievable targets (71.4%); attractive payment (60.9%); training and education on plan given to employees (37.3%); top management support for scheme (65.8%).
The implementation of flexible pay systems in Singapore was facilitated by the existence of one of the most important conditions for effecting major change in industrial relations and human resource management policies and practices, namely, a consensus arrived at through tripartite dialogue. The result of this is reflected in the following statement of Lim Boon Heng, Deputy Secretary General of the National Trade Union Congress in Singapore:

"Singaporeans have learnt a valuable lesson from the 1985-1986 recession - that we have to keep our wage costs competitive. Our wage payment system must therefore be flexible enough to adjust to changes in business conditions. At the same time, the system should also be effective in motivating employees to strive for excellence. A flexible wage system has also to be fair to employees, rewarding them in good times, and allowing for wage restraint without traumatic measures."

**Western Europe**

In the 1960's, and especially in the 1970's, the pay of non-executive categories in Western Europe was influenced largely by unions through the collective bargaining process. Consequently, employers had less capacity to introduce performance as a criterion in pay increases. In Britain, in addition to this factor, in the 1970's "the granting of pay increases for increased productivity was actually outlawed during several years of incomes policy because of the number of phoney deals used to bypass incomes policies". In the 1980's, as pointed out by David Marsden, the main thrust of employers on pay was two fold. The first was for the purpose of restoring the skills and managerial pay differentials which had been narrowed in the earlier decade, with the exception of Germany. The second trend was to try to link pay increases to enterprise and individual performance as far as possible. However, the potential costs of re-negotiating pay agreements to take into account performance, the establishment or re-designing of appropriate appraisal...
systems needed to operate a person based pay system, and employee preference for the security offered by traditional pay systems constituted obstacles to introducing major changes.

In France there was a move in the 1980's towards merit pay affecting a large number of employees, but the quantum of rewards was small. Though 42% of employees benefitted, yet of a 4.7% average increase in pay only 0.9% was by way of merit increases. In addition to collective bargaining having the strongest impact on wage increases, considerable difficulty was encountered in arriving at agreed performance criteria. Profit sharing has been a part of legal obligations in France covering, as at 1986, about 41/2 million employees in over 12,000 organisations. But payments have been small though varying from sector to sector - about 1-3 1/2% of average earnings. In the case of productivity-related pay, in the mid 1980's only about 6% of agreements had provisions relating to productivity.

In Britain, despite an increased use in the latter half of the 1980's of performance appraisal systems to assess performance rather than to determine promotions, the incidence of merit pay up to then had been little. Merit pay systems were operated more in the financial sector and in relation to white collar employees. The quantum has been small, estimated at 1/2% of earnings in the case of blue collar employees. Share ownership schemes in Britain increased by 1984 from 13% to 23% of companies, largely in the financial sector. Although most schemes are open to non-executives, the low rate of employee participation has not been encouraging. A Department of Employment survey indicated that 21% of enterprises surveyed operated profit sharing or share ownership schemes for most of their employees, the financial sector again being in the lead. Productivity bargaining between 1980 and 1987 increased to about 10% coverage of blue collar employees in manufacturing, and about 28% of agreements dealt in some way or another with productivity, and resulted in increased earnings.

Recent research has established that during the last ten years there have been substantial changes in pay systems in Britain. This is clear
from the several Workplace Industrial Relations Surveys conducted from time to time. As the Confederation of British Industry points out: 87

"In the last decade or so, pay determination in the private sector has become less a mechanistic process to be administered and more an active ingredient in bringing about and underpinning change. Private sector pay determination has moved from industry level to the company and ultimately to the individual plant. Along moves to pay decentralisation have gone the introduction of various forms of performance related pay. Out went automatic service related increments, and in some cases automatic annual 'cost of living' increases, to be replaced by rewards related to market movement and target achievement against specifically agreed objectives and competency levels."

By 1993 59% of the major pay decisions in manufacturing covering blue collar workers were taken at plant level, and in the case of other categories the figure was 65%. Employee attitudes surveyed revealed that they still believed that cost of living should be the main factor governing pay increases. But significantly, 41% recognized that individual performance was very important, while 32% thought that profits should be the main consideration governing pay increases. About 74% of large and medium size employers were using some form of performance related pay, covering about 66% of their employees; 1.2 million employees had some part of their pay directly linked to profits. 34% of employers operated share schemes for all or for some employees. Merit pay and financial participation schemes (profit sharing and share schemes) are the commonest form of performance pay especially for non-blue collar employees. Individual and group related performance pay have become common for blue collar employees. During the second half of the 1980's collective bargaining over pay declined in importance, and the proportion of full time employees covered by collective bargaining declined from 47% to 34%.
These trends have led some analysts to conclude that pay is the least flexible aspect of labour market flexibility trends in Western Europe (at least up to the end of the last decade). Based on evidence from Britain, France, Italy and Germany, David Marsden concludes that merit and performance related payments are small as a proportion of earnings, so that it is unlikely that "they have contributed greatly to increased flexibility in reward systems, in employers' labour costs, or in calling forth greater flexibility of work practices or greater motivation". Some of the reasons for this are summed up by Alan Gladstone:

"In all these moves there has been resistance by trade unions who often see wage flexibility as employers scheming to increase profits at the expense of the workers or as yet another threat in the name of 'flexibility' to rights won through social struggle over the decades. Moreover many unions have been traditionally opposed to payment by results and profit-sharing as being mechanisms which are exploitative and over which they, the unions, have little control."

Considering the situations of many industries in Europe in the current decade, and with Germany recording the highest labour costs, it is possible that the current decade will see flexible wage systems increase in Europe.

In Sweden, interest in reward systems was generated in consequence of a pay policy programme adopted in 1979 by the Swedish Employers' Confederation (SAF). This programme was intended to promote the development of, and information about, pay systems linked to results. The SAF believed that pay tied to results could complement the traditional salary systems, and it was not necessarily in conflict with them. As a result, many small companies introduced a complementary salary system based on the financial results of the company. In many companies improvements in results ranging from 10% to 25% were noted. The formulation of a yardstick of results that would affect the level of pay, as well as quick and continuous monitoring of results, was empha-
sised. Consequently employee interest in company earnings increased, and they made effective use of working time and materials, cooperated with and stood in for each other, and "blue collar and white collar employees worked together as a team with greater commitment and towards common goals." The 1983 pay agreement covering white collar employees provided for enterprise level agreements to cover payment by results schemes. Agreements reached between the SAF and its trade union counterpart have particular significance in Sweden because of the very high rate of membership in both the trade union and the SAF. The SAF found the following four factors to be of particular importance in formulating a yardstick of results:

(i) Relevance i.e. it should relate to the overall goals and results of the company.

(ii) The yardstick should be as simple and objective as possible.

(iii) The yardstick should be easily understood and it should be capable of being influenced by the performance of employees.

(iv) It should be flexible in relation to normal changes that take place in external factors which affect the circumstances of the company.

The emergence of profit sharing and stock ownership schemes in Sweden in the 1980's resulted, by the end of that decade, in about 25 per cent of employees in the private sector being covered by profit sharing schemes, and about 33 per cent by employee stock ownership schemes.

The SAF quite pertinently points out that a profit sharing scheme has a value beyond the money involved - as a tool for communication. It is unworkable without the disclosure of relevant information which must be accurate and reliable.
The current thrust of employers in Sweden to decentralise pay determination to enterprise level is reflected in a Swedish Employers' Confederation (SAF) publication. They argue that pay should generate revenues and profitability. It is compensation for work done, competence and responsibility which increases revenues and profitability, and compensation should generate the growth of both the company and its employees. Companies, which were hitherto production driven, have been compelled to become business and market driven, and:

"In the 'flatter' organizational structure that is emerging, demands on individual and highly company-specific qualifications are increasing. The old way of thinking in terms of more or less static positions is on the way out. A more dynamic way of viewing job tasks is instead evolving. The concept of 'competence' (=skills, expertise, qualifications, education etc.) will gradually replace the concept of position".  

When performance, responsibility and knowledge can influence pay setting, the individual can influence his pay level and increase his earnings without adverse effects on competitiveness. According to employers in Sweden, the following should be the goals of a pay system, and they claim that there is a basic consensus in regard to them:

- A. Save and develop jobs.
- B. A stable national economy - a dynamic and growing national economy with low inflation.
- C. A well-functioning labour market with flexibility for both companies and individuals.
- D. Wages and salaries shall reflect the individual's competence and job performance and serve as an incentive for development on the job.
- E. Consistent wage setting - wages shall be set consistently and systematically, not arbitrarily.
- F. Wages shall contribute to increased efficiency, profitability and competitiveness in the companies".
In Norway, the results of a survey by the Confederation of Norwegian Business and Industry (NHO) in 1993 on pay systems in 1043 companies with more than 20 employees (outside the metal industry) revealed the following:

(i) 42% operated some form of bonus payment system. 21% of them based the system on productivity improvements, 29% on the economy and 23% used a mixture of economic and productivity criteria.

(ii) In the case of 35% of the companies the system applied to all employees, and in the case of 52% application was confined to particular groups.

North America

Developments in the USA have been referred to in the preceding sections. In relation to developments in the last decade, Thomas A. Kochan and Anil Verma refer to the trends towards flexible pay, which indicate, for example, that 25% of firms surveyed in Canada had profit sharing schemes, 10% had gain-sharing and 8% pay-for-knowledge schemes. Profit sharing schemes have been operated in the USA particularly in the automobile and steel industries. Even in the 1980's in the automobile, airlines and meat-packing industries there was a move towards profit-sharing and performance pay type of schemes, and less cognizance of cost of living and other compensation factors. Union opposition to profit-sharing schemes has been relatively greater in Canada than in the USA. Thomas T. Kochan and Anil Verma refer to the view generally held by industrial relations experts that the spread of performance and profit related pay is unlikely to be pronounced unless changes take place in two important areas. The first is the need for greater information-sharing with employees, especially on economic performance and business plans, with opportunities to influence these plans. The second is the need to correct internal inequities in pay resulting from large differentials between executive and non-executive pay and benefits. The disparity increased in the 1980's in both the USA
and Canada. The large differences in managerial and non-managerial pay cannot be explained on the basis of paying for talent, because the position is quite different in well-performing enterprises in Germany and Japan. In Japan the trend has been to narrow the gap. Among the consequences of these huge disparities are probably the reduction of effectiveness of profit-related pay in securing better performance among non-executives. Another consequence is that it increases the job losses of less skilled people. In the American executive pay system managers are generally not known to suffer income reductions when the enterprise performance is poor. It has been pointed out that:

"Whether new compensation practices that involve contingent pay and new institutional arrangements that support such payment schemes spread to broader settings will depend on the willingness of management and labour to institute the institutional changes and reforms needed to support such plans. At this juncture, there seems little enthusiasm on the part of either labour or management leaders to make these changes".

Australia

Australia presents a rather unique picture in the context of flexible pay, because the relevant public authority has been responsible for introducing performance and efficiency factors into wage awards. The Australian Industrial Relations Commission has, since 1987, introduced the concept of performance in its wage awards. In 1987 the Commission granted a two-tier wage increase, the first of which was a general increase split into two parts. The second part provided for a wage increase not exceeding 4 per cent, subject to employers and unions agreeing to improve efficiency in the industry or workplace. "The Commission requested that the parties consider reforms to restrictive work and management practices, multi-skilling and broad banding of work classifications, reduction of demarcation barriers and changes to award
The 1988 National Wage Case Decision made the increase conditional on discussions between the two social partners on structural efficiency and an examination of, inter alia, skill-related career paths and flexibility. A similar trend was evident in the 1989 National Wage Case Decision.

I. CONCLUSIONS

In drawing a few conclusions of a tentative nature, several limitations need to be borne in mind. The success or failure of people-based pay systems is conditioned by both external and internal factors, such as the strength and attitude of unions, the collective bargaining traditions and even by cultural factors which impinge on motivation such as individualism and group orientation. No one scheme or practice in a particular country would be necessarily suitable for all or most enterprises. Pay, though a motivator, cannot stand alone in achieving corporate performance, productivity and profitability. However, several matters could be underlined by way of conclusions, and the observation of Rosabeth Moss Kanter made in relation to the USA is of wider relevance:

"Ultimately, those payment systems that work will not be ones that encourage the competition-focused cowboys to rise again, getting what they can for themselves without taking the broader goals of the company into account. Instead, the successful systems will be those that balance the drives for individual achievement with the cooperative effort of the whole corporate team."

There is increasing pressure by employers in industrialised, newly industrialising and developing countries for more flexible pay systems geared to performance, productivity and skills. However, coverage by schemes appears to be fairly limited in terms of the number of employees. Some unions in the West still view such schemes as an erosion of their collective bargaining role, while some employees may see them as
placing at risk some part of their future earnings. Flexible pay systems cannot in any event replace, but can only modify, traditional systems based on job evaluation.

In introducing person-based pay, employers have a range of strategic choices in order to make them work. In making these choices they need to formulate specific objectives which fit into their business strategies. The schemes themselves should be geared to these objectives. Flexible pay systems are unlikely to be effective unless other appropriate human resource management policies and practices are in place, and do not run counter to the objectives sought to be achieved through a flexible pay system. For example, a pay system intended to improve and reward skills should be reinforced by a policy geared to upgrading skills (through training, etc.). Pay as a reward for performance should be designed in the context of other policies to motivate employees (e.g. intrinsic rewards) since pay per se will not result in better performance where other conditions are de-motivating. Pay systems can only reinforce a broader human resource management strategy. People's performance depends largely on two important factors. The first is their knowledge or skill which determines their potential to perform. The second is their work attitudes which determine their willingness to perform. Actual performance is secured by matching these two attributes, and how this should be done is the task of human resource management. For instance, in non-routine work, especially in jobs which call for the solution of complex problems, the degree of choice and control an employee has over his work and the degree of participation allowed in workplace decisions has an effect on performance. Therefore, increasing the skills of employees through training may not appreciably improve performance unless accompanied by strategies which have an impact on work attitudes and motivation.

The procedure adopted in formulating incentive payment schemes and the way gains are shared can be as important as the rewards themselves. Major changes of this nature are best effected through a process of consultation and ideally consensus, concerning objectives and the manner of sharing and rewarding. Issues such as whether a reward should be based on individual, group or enterprise performance, or a
combination of them, how performance should be measured and the frequency of payment, all present choices the proper selection of which will influence the success or failure of the scheme. Schemes should generally be as simple as possible, be perceived as fair, be periodically evaluated and blended with traditional pay increase mechanisms such as collective bargaining and pay systems. Where unions exist, winning their cooperation can be critical.

The problems of strategic pay systems are apparent when one considers the debates about the very value of such reward systems. It is therefore instructive to refer in some detail to one debate arising from the view expressed by Alfie Kohn\textsuperscript{109} that incentive rewards only succeed in securing temporary compliance, and do not result in long-lasting commitment to any value or action. His views are considered by nine others,\textsuperscript{110} and their varying responses referred to below indicate the continuing debate about the value of extrinsic rewards to secure commitment to high performance.

G. Bennett Stewart III (Senior Partner, Stern Stewart & Co, New York), argues in favour of linking pay to performance. In a consumer market people respond to monetary incentives when they spend income (e.g. price reductions), so that they are likely to respond also when they earn that income. This argument may not necessarily destroy the validity of Kohn's thesis, which argues that such incentives have a temporary impact and do not promote long-term commitment. Based on case studies, Eileen Appelbaum (Associate Research Director, Economic Policy Institute, Washington D.C.) supports Kohn's views. According to these studies employment security, gainsharing and incentives can only support a performance improvement programme. Performance can be improved more importantly through reorganising the work processes and the central elements in high performance are training, participative decision making, opportunities to contribute ideas and knowledge, and a fair sharing of gains from improved performance.

Michael Beer (Professor of Business Administration, Harvard Business School) agrees with Kohn to a limited extent. He is of the view
that unlike Continental and Japanese managers, American and British managers hold deep-rooted assumptions about the role of incentive pay in motivation. Consequently, the erroneous question often posed by the latter is: how to design an incentive system to obtain the desired behaviour, when the question should be: what role, if any, should incentive pay play? Management should endeavour to pay employees equitably, rather than use it as a motivational tool. Due recognition for performance should also be extended through other means. According to Andrew M. Lebby (Senior Partner of the Performance Group):

"Money is an outcome of high performance. Satisfaction and respect are incentives to it". 111

Other factors such as a sense of accomplishment, recognition, career advancement and management support are greater motivators. Teresa M. Amabile (Professor of Psychology, Brandeis University) agrees with Kohn to the extent that monetary rewards are not the key to high performance, and incentives which take the form of "bribes" can be counter productive. But she recognises that pay can motivate if it is seen as equitable.

Jerry Adams (Vice President, Performance Improvement Resources) believes that appropriate incentive systems do have positive effects. He agrees with Kohn that reinforcement of tasks through rewards can have negative effects, and that:

"Measuring and rewarding on an individual level (sales excepted) does tend to become controlling. The focus should be on business objectives, not tasks.... rewarding groups of employees, usually whole plants and offices, is a powerful business strategy". 112

The Chairman and CEO of Tyco Laboratories Inc., New Hampshire, L. Dennis Kozlowski, attributes the company's business success to its incentive system. George P. Baker III, Associate Professor, Harvard Business
School, argues that the effectiveness of incentives depends on their being used to promote the right behaviour, and that otherwise they will result in behaviour not intended. For example, if a scheme rewards individual results when the desired result is teamwork and cooperation, the reward system will be counter productive. Rewards should seek to influence results rather than behaviour. Donita S. Wolters (Manager of Human Resources, JMM Operational Services, Denver) points out that poorly designed incentive plans are damaging where they transmit the wrong message about an organisation's values and priorities, and agrees with Kohn that training and goal setting are more effective strategies for improving productivity.

In responding to these views Alfie Kohn reiterates his thesis and claims that incentive plans are based on a flawed theory of motivation. He states that to the best of his knowledge "no controlled study has ever found long-term improvement in the quality of performance as a result of extrinsic rewards", and that in regard to compensation in general and pay for performance in particular:

"Neither can produce quality, but only the latter is positively harmful .... Offering good things to people on the condition that they do what you tell them is, almost by definition, a way of trying to exert control".  

Alfie Kohn concludes his response with the following statement which should not be interpreted to mean that money is unimportant, but rather that so long as pay is equitable, the strategies to secure high performance should be non-monetary (intrinsic rewards); and, further, that gain sharing is desirable because it is fair but should not be used as a manipulative tool:

"... pay people well and fairly, then do everything possible to help them forget about money. I have no objection to profit-sharing: it seems sensible enough that the people who made the profit ought to have it.... My concern is
primarily to convince managers to stop manipulating employees with rewards and punishments and to stop pushing money into their faces. My other concern is to emphasise the futility of fiddling with compensation schemes. This is not the road to quality.... I find it useful to think in terms of three C's: choice, collaboration and content. Choice means that employees should be able to participate in making decisions about what they do everyday. Collaboration denotes the need to structure teams in order to facilitate an exchange of ideas and a climate of support. Content refers to what people are asked to do: as Frederick Herzberg said: 'If you want people motivated to do a good job, give them a good job to do' ....Innovation and excellence are the natural results of helping people experience intrinsic motivation. But intrinsic motivation cannot survive in an organisation that treats its employees like pets". 115

However, a considerable body of evidence supports the link between pay rewards and motivation. 116

No recommendations applicable to the design of compensation systems for all types of organisations are possible. Strategic pay systems are difficult to transplant because, as pointed out by E.E. Lawler 117, in "many respects innovative strategies are hard to copy because they are more than just technology: they are a social system, a management philosophy, and a way of operating that permeates the entire organisation". However, some general guidelines could follow once the enterprise's business strategies and work culture are, as pointed out by Robert Wood 118, decided on. He provides the following examples of recommendations, adapted from the work of L.R. Gomez-Mejin and D.B. Ballua : 119
(a) When organisations are pursuing entrepreneurial growth strategies they should offer employees in the growth areas large bonuses, based on objective measures of individual performance for clearly identified projects. High earnings risk is highly motivating for entrepreneurs who tend to have a calculative involvement in organisations. When projects fail, the costs to the organisations are minimal. Once projects succeed and are established, a new manager, employed under a different compensation package, should replace the entrepreneurial manager.

(b) Organisations that are pursuing cost reduction strategies in single product markets with well established technologies should focus performance pay on efficiency and service measures of performance. The level of pay "at risk" should be adjusted according to the labour market conditions. In tight labour markets, the earnings risk may need to be lowered in order to attract and retain good employees.

(c) In complex organisations with high technical and organisational knowledge requirements, the amount of pay "at risk" should be kept low and compensation should be used to bond employees to the organisation. Skill based pay systems can be used to pursue technical leadership strategies and to retain highly skilled staff in technical areas.

The following represent some general principles which need to take into account in introducing strategic pay systems:

(i) Performance pay should be designed to promote the kind of performance and behaviour which a particular organization needs. This implies that performance pay should be part of an organization's overall human
resource management strategy. It cannot stand alone - if it did, it could be counter productive and result in the type of behaviour which is the opposite of what the organization aims at. Where the organization's means of achieving its goals are, inter alia, team or group effort, it is counter productive to introduce a form of strategic pay which aims at promoting individual performance.

(ii) Designing a pay system should be preceded by an analysis of what are the objectives and results sought to be achieved, and thereafter establishing the principles and practices which can achieve these results.\(^{120}\)

(iii) Since rewards must have the desired effect, they should motivate the recipients in the direction intended. In some cases it may not be financial. Therefore consulting employees helps to identify rewards that work.

(iv) The standards or criteria on which performance pay is determined should be objective and measurable. There should therefore be a performance appraisal system which measures performance in terms of the relevant criteria.

(v) No extrinsic reward system is likely to work unless employees are satisfied with the intrinsic reward of the job. Therefore, increasing job satisfaction and job responsibility, consulting employees in decision making, re-organizing work processes, training, providing opportunities to contribute ideas, should all form part of the management culture if extrinsic rewards like strategic pay systems are to be effective.

(vi) How rewards are shared can be as important as the quantum. Perceptions of lack of fairness, especially where management staff capture the lion's share of
rewards for reasons of status rather than performance, can render strategic pay systems de-motivating.

(vii) Strategic pay systems should be sufficiently simple and easily understood by the beneficiaries.

(viii) The frequency of payment can be important. The reward should follow within a reasonable time of the completion of the performance, if the beneficiary is to see a clear connection between the performance and the reward.

(ix) A reward which is known only to the recipients and a few others often lacks motivational power. To motivate, the fact that particular individuals received a reward should be known to others. Whether in some cultures recipients would prefer some degree of 'secrecy', especially where the reward is financial, would require investigation and research.

(x) The performance level should be achievable by as many people as possible. A performance level achievable by only a very few will motivate only the few who perceive the standard as achievable. For this reason profit-sharing plans tied to the overall profits of an enterprise may have only a limited influence, because an individual would find it difficult to see how his own behaviour impacts on the overall profit.

(xi) A bonus or gainsharing system to reward individual or group performance- preferably both - has the advantage of not increasing labour costs, reducing redundancies and establishing a clear link between performance and pay increases.
(xii) Every organization needs to determine how much of pay increases should be 'placed at risk' and be subjected to fluctuations conditioned by performance. A wrong decision would adversely affect performance.
NOTES


7. For example micro electronics, biotechnology, the new materials science industries, telecommunications, civilian aviation, robotics plus machine tools and computers plus software - see Lester Thurow Head to Head (Nicholas Brealey Publishing Ltd., London, 1993) at 30.

8. Lester Thurow, ibid. at 40.


10. See E.E. Lawler Strategic Pay, op cit.

11. Rosabeth Moss Kanter When Giants Learn to Dance, op. cit. at 232.


14. "The Mythology of Management Compensation" in Readings in Human Resource Management, ibid., 434 at 450 note 1. See ibid. at 435 et seq. for the role of pay as a motivating factor. On this whole question see also the debate referred to under "Conclusions" in this chapter.
16. Ibid chapter 3, for establishing core principles.
17. For the relationship between performance appraisal and pay, see E.E. Lawler, *ibid.*, chapter 6. It is important that employees should be involved in both the assessment of performance and in the action to improve future performance. Assessment should be of what a person does and therefore has control over, and not of what a person is, which is fixed. In other words, appraisal must be not of personal traits but of behaviour and outputs, and the criteria should be job related.
20. E.E. Lawler *Pay and Organisation* (Addison-Wesley, Reading, Massachusetts, 1981). See *ibid.* for other strategic choices such as deciding between internal and external pay equity, surveying the right markets, and centralization and decentralization in the design, implementation and administration of a compensation system.

25. People, Pay Bill and the Public Sector (Confederation of British Industry, U.K, 1994) at 15. See this publication Chapter 3 for how strategic pay systems are operated in several British undertakings.
26. ibid at 22-23.
27. See ibid. for the key factors under this heading.
32. Rosabeth Moss Kanter When Giants Learn to Dance, op. cit. at 264.
33. Ibid.
35. Robert G. Eccles, ibid. at 131.
36. OECD Economic Studies (No.18, Spring, Paris, 1992) at 120.
37. Ibid at 121.
39. Rosabeth Moss Kanter When Giants Learn to Dance, op. cit. at 236.
40. "This problem can often be laid at management's door. When workers respond to piece rates by increasing output (and their income) management has often cut piece rates. Workers in both union and non-union enterprises quickly learn to establish and enforce output norms and to conceal new and more efficient work methods in order to avoid a de facto speed up by rate-cutting": OECD Economic Studies, op. cit. at 119.
41. Ibid
43. E.E. Lawler *Strategic Pay*, op. cit at 110.


46. See Shozo Inoue *ibid.* See Table 4 for various formulae.

47. See *ibid.* See Tables 5 & 6 for direct and indirect distribution formulae.


52. *Strategic Pay*, op. cit. at 112.


54. Taken from E.E. Lawler, *ibid* at 115-116.


56. 1988 *Profit Sharing Survey*, op. cit. See Gary W. Florkowski "Profit Sharing and Public Policy: Insights for the United States" in 1991 (vol.30) *Industrial Relations* 96-115 for public policy on profit sharing in the USA. The push for more tax incentives for profit sharing is based on the belief that profit sharing has a positive impact on employment and productivity. See at 102-108 for the extent of and attitudes towards profit sharing in some European, Asian and Latin American countries.


Case Studies from Malaysia, Philippines & Singapore (International Labour Organisation, 1989).


60. Ibid. at 358. For the effect of ESOPs on Japanese firm performance see at 363 et seq.


63. Skills based pay does not mean that the whole or larger part of pay is linked to skills, or that skills in the only criterion for pay increases. Skills would be the criterion for increases beyond the general level of pay increases, either for skills acquisition or for skills acquisition plus performance on the job.

64. Strategic Compensation: Paying The Person, op. cit.

65. Ibid. See E.E. Lawler Strategic Pay, op. cit. at 160-176 for the advantages and disadvantages of skills based pay.

66. See E.E. Lawler Strategic Pay, op. cit. at 164.

67. Skill Based Pay (Incomes Data Services Ltd. study, U.K. 1992) at 1.


69. Rosabeth Moss Kanter When Giants Learn to Dance op. cit. at 253. See also at 254 et seq. for other examples.


71. Ibid. at 178.


73. When Giants Learn to Dance, op. cit. at 255.

74. "The Knowledge-Creating Company" in 1991 (vol. 69 No. 6) Harvard Business Review 96. See this article for how Japanese learning enterprises place knowledge creation at the centre of a
company's human resources strategy, and how knowledge is not regarded as only a processing of information, but also a harnessing of the insights, intuitions and hunches of individual employees for application in the company.

75 **When Giants Learn to Dance** op. cit. at 262.
76. See E.E. Lawler **Strategic Pay**, op. cit. at 31.
77. The author wishes to thank the Executive Director of the Singapore National Employers Federation (SNEF) for much of the information on Singapore. For a study made up to 1987 see Lee Kok Wai **Flexible Wage System** (Singapore Institute of Management, 2nd Edition, 1989). It sets out, among other things, the several recommendations made by the National Wages Council in Singapore on the subject of flexible wage systems, examples of numerous possible schemes and plans etc.

79. **Ibid.** at 21-30.
80. See **Ibid.** at 30 for a list of the type of problems experienced by 78% of the companies.
81. In the Foreword to Lee Kok Wai **Flexible Wage System** op. cit.
83. **Ibid.** at 59-62.
86. See Mark Beatson "Trends in Pay Flexibility" in 1993 (September) **Employment Gazette** 405-428, the Incomes Data Servies Study **Skill-Based Pay** (February 1992, U.K) for a detailed analysis of six companies which operate a skill-based pay system for their blue
collar employees, the Confederation of British Industry (CBI) public- 

ation People, Paybill and the Public Sector (CBI, London, 1994). The 

uthor wishes to thank the CBI for furnishing him with the material.

People, Paybill and the Public Sector, op.cit at 7-8.

"Have Pay Systems Become More Flexible in Western Europe in 
The 1980's?", op.cit. See at 66-69 for the composition of earnings in 
France, Italy, Germany & Britain from 1972 to 1984.

"Introduction" in Labour Relations in A Changing Environment, op. 
cit., at 4.

Tommy Hellstrom, SAF, "Payment By Results for White Collar 
Employees" in the Proceedings of New Trends in Reward Systems, 
an International Experience Exchange Meeting (1984), organised by 
the European International Committee for Work and Pay, published 
by the Swedish Employers' Confederation (March 1985) at 1-23.

Ibid. at 15. See at 15-21 for examples of measurement criteria and 
pay schemes introduced in companies, for the company as a whole 
and at departmental or unit level.

Ibid. at 19-20.

The author wishes to thank the Swedish Employers' Confederation 
for making available material on the subject.

Mats Andersson, Laila Eriksson, Tommy Hellstrom, Anders Rottorp 
and Bo Sunden Good Pay Formation (SAF publication, Gummessons, 
Sweden, 1994).

ibid at 18-19.

ibid at 42-44.

ibid at 42. The first goal is achievable through moderate cost 
increases coupled with pay which encourages employees to enhance 
their competencies. Goals D & E are therefore important to the 
achievement of goal A. Achieving goal B depends on goal F. See ibid 
at 43. On how to achieve good pay formation see ibid 53-73.

The author wishes to thank the Confederation of Norwegian Business 
and Industry (NHO) for the information in the text.

"A Comparative View of United States and Canadian Industrial 
Relations: A Strategic Choice Perspective in "Labour Relations in 
A Changing Environment,op. cit,187 at 190-192.

102. *Op cit* at 191. In 1988 Chrysler and the United Auto Workers' Union agreed that executives would not receive bonuses in years in which blue collar workers do not receive them due to the enterprise's performance.


107. See *ibid.* at 114-115 for union dissatisfaction with the Commission's decisions in 1991.

108. *When Giants Learn to Dance, op. cit.* at 266.


111. *Ibid.* at 42.


117. *Strategic Pay op. cit.* at xiii.
118. **Strategic Compensation**: "Paying The Person," *op. cit.*.


120. E.E. Lawler *Strategic Pay, op. cit.* chapters 2 and 3.