Extension Material 13.3

Common pay systems

Basic or fixed rate

Most payment systems are based on a basic rate or have a basic rate element to them. Under such systems a worker is paid in relation to a given period of time—an hourly rate, weekly wage, or annual salary. Generally, this rate is the established rate for all workers in the same category. Flat rates can be associated with incremental scales which allow for increased hourly rates based on experience skill and responsibility. Basic rate pay systems have the advantage of being relatively simple and involve limited administrative costs. The advantages for employees are that their wages can be easily calculated, and are relatively stable, but their defining feature is that hourly or fixed wages/salaries are not directly related to employee performance or output although employee control over performance varies considerably between occupations and jobs. Partly because pay is not variable except in relation to time worked, and in the case of salaried employees this may not be a condition of the employment contract, these kinds of pay systems involve fewer disputes and disagreements than those related to performance. The implication of this, however, is that employee performance has to be managed without the contribution of financial incentives. Another important feature of fixed rate schemes is that individual performance differences are not reflected in differential hourly rates or wages/salaries. This means that people doing the same job but to different levels of performance get the same pay; a situation that can create tension over the question of fairness. Such schemes are found in the manufacturing, retail, hospitality, and transport sectors, but also in teaching, the health service, and local authorities; much less in IT, banking, and finance, although as far as basic pay is concerned they are to be found in most sectors of the economy.

Input-based

These are not alternatives to basic or fixed rate payment schemes but are often built into or added onto them. They involve pay enhancements, or progression through a grade, based on employees' acquisition of skills through approved training and professional development programmes. Job evaluation schemes would fit into this category. Competency-based schemes operate in similar ways but involve employees meeting criteria for being designated competent or possessing certain required competencies (Perkins and White, 2011). Additional pay increments can be used to encourage the development of new skills/competencies at the same level but also across job boundaries (functional flexibility in a horizontal sense) and/or acquiring higher-level skills within an existing job/occupation (functional flexibility in a vertical sense). The potential advantages of these kinds of payment systems is that they reward employees for becoming 'higher value' and more productive, can represent part of a retention strategy, and offer personal growth and progression in the absence of a formal career ladder. One problem, however, is that payment for skills/competencies that are not used in a productive way becomes problematical and costly and perhaps more importantly it can lead to a psychology of expectation where employees equate additional skills and qualifications with additional payments. Another is the problem of defining and measuring higher and more complex skills and competencies and the tendency for such systems to become overly bureaucratic and complicated (Riley, 2003).

Performance-related pay or variable pay systems

Piece rates

Piece rate systems are probably the oldest example of pay that varies according to some agreed or imposed relationship with performance or output (the two can mean the same in certain kinds of work). A piece rate means that an employee is paid for each item of work, or amount of work completed. Historically they have been linked to industries such as manufacturing, construction, and mining and they can still be found today where the kind of work involved lends itself to easy measurement and involves repetitive activities. In 'pure' piece rate systems, either total or partial payment is based on units/output produced but more often today payments are made for additional output over and above that which is determined or agreed as being the daily or weekly norm. For example, a bricklayer or a team would be expected to lay so many bricks per day/week for which a standard hourly rate would be paid. Bricks laid in excess of this base line would elicit additional payments not as an enhanced hourly rate but as a bonus based on an agreed formula.

Taking another example of piece rates, in garment manufacturing each job is divided up into separate components and each is timed (time study) to establish how long it should take to carry out that particular task (standard time). The employee can then increase their actual rate of pay (and earnings) when carrying out these tasks by working at a faster rate than the standard time. This works on the basis that in a thirty-five-hour working week the output produced/

jobs completed has to equate to thirty-five standard hours' worth of work. Producing output in excess of this figure means that a person's pay could be the hourly rate of pay multiplied by forty or forty-five hours. Often payment for this additional output is capped at a maximum of, for example, 20 per cent extra to ensure pay doesn't get out of control.

Piece rate systems encourage workers to try to stick to the jobs that they can do best and naturally tend to make employees reluctant to do work that does not offer the prospect of earning additional pay. Staff can therefore be reluctant to participate in off-the-job training or meetings to help improve productivity, because of the loss of wages that this involves. Production changes may not be welcomed because these can result in tasks being retimed at less favourable rates; staff may be tempted to compromise on both quality and health and safety, to maximize their output to achieve higher earnings. Repeating the same task over a long period of time can also cause medical conditions known as upper limb disorders or repetitive strain injuries. Regularly rotating people around different tasks and allowing employees to take regular breaks can reduce the risk of this type of injury, but piece rate systems can make it harder to implement measures to minimize the risk of employees developing these types of problem at work. Piece rates are not normally associated with employee flexibility, and given that functional flexibility is an increasingly key requirement for adaptive and responsive organizations, they can become an obstacle to achieving this objective.

The term 'payment by results' (PBR) is often used to describe payments systems where pay varies in relation to an agreed measure of output and is therefore synonymous with performance-related pay (PRP). 'Incentive-based schemes' is a more inclusive term and covers all systems that have an incentive element where the reward can take different forms. Piecework is one version of PBR: different kinds of bonus payments are another where either a fixed or variable bonus is paid for agreed targets/output levels being achieved. Where work is measured in financial rather than by physical or spatial measures, bonus schemes are frequently based on the achievement of financial targets or the value of sales. Commission payments are associated with selling or achieving a certain level of income for the business in question and can represent 100 per cent of a person's earnings but more likely between 25 per cent and 50 per cent depending on the scheme's design. Most commission-based schemes are additional to an element of basic pay. Achieving targets/levels above a certain level results in bonuses being paid and the size of the bonus in relation to basic pay can vary at different points on the bonus curve (see Figure 13.3).

Designing bonus schemes is more complex and challenging than Figure 13.3 suggests. Incentive-based bonuses for senior managers can involve several differently weighted measures of performance with more than one bonus payment available (Pepper et al., 2013). The real challenge is not simply deciding on the level of bonus payment or the point on the performance axis it is paid but also on the choice of what is to be used as a measure of performance and the metrics to be used in monitoring changes. This difficulty is highlighted in the Work Foundation report by Kay (2014) into the

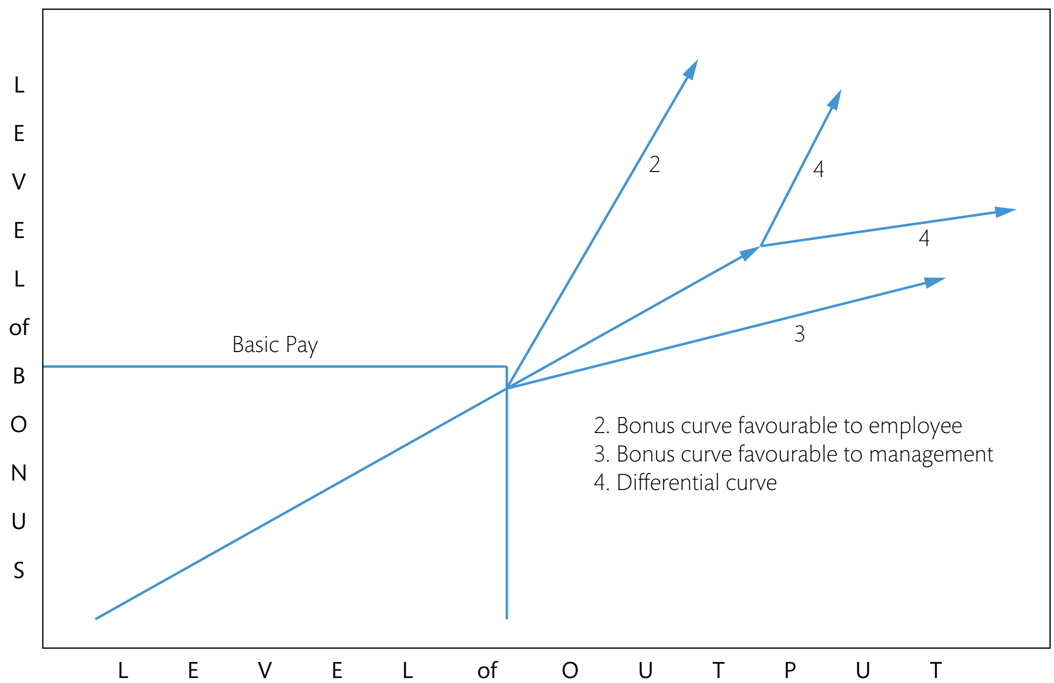

Figure 13.3 Depiction of different bonus curves showing bonus in relation to output/performance

experience of public sector incentive/PBR schemes. The report highlighted what it described as the complexity of the public service 'good' and went on to state that:

> **By their nature, public services generate a multitude of outcomes, and thus their objectives are not clear-cut. In education, for example, these may encompass examination results, attendance, engagement in learning, citizenship, creativity, vocational skills, etc. In health, this could include the number of procedures performed, mortality rates, the patient experience, equity of health outcomes or broader measures of wellbeing or quality of life. A PRP scheme in the public sector has to identify and prioritise these various objectives. In addition, the ultimate outcomes of many activities performed in the public sector–educational performance, trends in crime rates, or health outcomes–may only be visible in the long-term, raising questions about the feasibility of accurate and meaningful performance measures within a PRP scheme.**

There is an interesting tension between the growing use of PRP in the public sector and difficulties in agreeing on what performance means and how it should be measured but the limited success of such schemes in this sector is at least likely to be linked to this problem.

A form of PRP used particularly with white-collar and professional employees is appraisal based or linked to the assessment of merit. Merit-based pay is less popular than it used to be as performance appraisal (PA) schemes have grown in popularity. This approach to pay is generally used to link a salary increase or an annual bonus to an assessment of an individual's work performance during a particular reference period, often a year, although time periods vary depending on the design of the PA scheme. Assessments usually relate to an individual's achievements against agreed objectives or criteria relating to output and quality of work but which may also include an element of evaluation of personal characteristics, such as adaptability, initiative, leadership style, etc. Despite the continuing popularity of PA schemes, serious questions have been raised about their effectiveness at changing behaviour and whether they do in fact result in any meaningful change in the level of performance (Coens and Jenkins, 2000).

Collective PRP systems

Group/team bonuses

Another payment system, frequently used to encourage employees to complete more work in a given time or meet targets, is a group bonus. Schemes vary depending on the organization, the nature of the work, and the number of people employed, but typically involve measuring the performance of a group of people and awarding a payment to the group for increased output or meeting predetermined objectives. Each member either receives an equal portion of the bonus or pro rata payments that reflect different contributions or pay rates. For example, certain team members may receive 120 per cent of the bonus, the majority 100 per cent, while others who may be junior or inexperienced 80 per cent. Different individual performance levels within the group can be a source of disagreement and conflict which, without intervention, can damage relations and result in overall performance levels falling as the intragroup conflict affects cooperation. Other factors can be linked to payment in addition to performance such as the team's health and safety record, quality achievements, or the team's attendance records. The more factors that are included in the calculation of the team or group bonus, however, the more complicated pay administration becomes. Recent research by Garbers and Konradt (2014) is supportive of group-based pay as an addition to basic pay, but they suggest that some element of individual performance-related reward needs to be included, with an emphasis on equitable rather than equal pay. They also found that this approach to pay is less effective in larger and more diverse teams, and where tasks are more complex.

Gain-sharing schemes

These operate at the level of the whole workforce and are based on the principle that through sustained collective efforts rather than relying on individual effort to boost performance, organizations can either save money and/or increase productivity. Such schemes originated in the USA where they are still relatively common and well established. In the UK, however, according to the CIPD (2013), only 11 per cent of firms surveyed were operating such a scheme.

The Scanlon plan is perhaps the best-known example of gain-sharing. Joseph Scanlon designed this plan in the early years of the Great Depression to save enterprises threatened by the economic collapse. He believed that if 'workmen' are allowed to contribute to an organization's decision-making process, the goals of the 'workmen' and the employer would be common and both would work in coordination to achieve such goals. He believed that such plans were instrumental in ensuring stability in the labour–management relationship in a highly volatile era and as with certain other payment methods are based on a set of beliefs and values about how organizations should be run. In this sense, he was very similar to F. W. Taylor in that they both approached the management of people and the running of an organization from a strong philosophical framework.

To help in understanding how the plan works, the following explanation will help:

> **If a plan is implemented and successful, all employees usually share in 75% of the savings. For example, assume that the normal monthly ratio of payroll costs to sales is 50%. (Thus if sales are £600,000 payroll costs should be £300,000.) Assume the firm implements suggestions/changes that result in payroll costs of £250,000 in a month when sales were £550,000 and payroll costs should have been £275,000 (50% of sales). The savings attributable to these suggestions is £25,000 (£275,000 minus £250,000). Workers would typically share in 75% of this (£18,750) while £6,250 would go to the firm. In practice, the firm sets aside a portion as a reserve, usually one-quarter of the £18,750 for the month in which payroll costs exceed the standard. Bonus payments are therefore evened out and regularly paid rather than paid intermittently.**

Two other less well-known gain-sharing plans are the Rucker plan and what is called Impro share and are based on similar principles of cost savings (labour) or value added expressed in terms of sales value. The Rucker plan uses a value-added formula. Here the employer divides the value added for the period (basically net sales minus the cost of materials, supplies, and services such as utilities) by total payroll expenses. With the Impro share plan, the bonus basically depends on the difference between how many labour hours the company should have used for the period, compared with how many it actually used. Most firms use custom-designed versions of these plans. Again, the idea is to liberate employees from seeing their contributions purely in terms of their jobs and to emphasize the additional contributions that can and should be making to the organization. The payment of a bonus when the schemes are successful is more a reward for these collective contributions than acting as an incentive, although people's perceptions may differ on this point.

Financial schemes

Evidence on the use of profit-sharing schemes, van Wanrooy et al. (2013) indicated that some 32 per cent of organizations used some form of profit sharing although the rules governing such schemes vary considerably. Despite minor variations in the rules governing these schemes the principle is the same, where an agreed proportion of profits is made available to its employees in the form of an annual bonus. The CIPD reward survey (2013) found that respondents rated profit sharing as the most effective variable reward scheme available to them. Whole organization profit-sharing schemes link financial performance to annual bonuses which are paid either as a fixed amount to all employees or more usually pro rata to wages/salaries. While the incentive effect is diluted in the sense that the bonus is paid annually and the prospect of receiving this additional payment may not impact on their behaviour on a daily basis, this may be a strength rather than a weakness. Moreover, the kinds of unintended consequences associated with individual PBR schemes are not found in profit sharing: sharing in the organization's success helps to create a sense of shared rather than divergent interests and helps to focus the efforts of both managers and employees on creating the conditions which are likely to result in successful financial performance. One obvious problem with such schemes, however, is that profitability is affected by factors beyond the efforts and commitment of employees. Where organizations struggle against difficult economic headwinds profits may fall and become negative; in such circumstances, the legitimate expectations of employees may not be met. Failure to deliver regular annual bonuses can result in these schemes losing credibility and effectiveness.

Perhaps the best-known profit-sharing scheme in the UK is the one operated by the John Lewis Partnership. The significance of this scheme is that the organization is owned by its employees who are legal partners in the business; most other profit-sharing schemes operate under different ownership structures. The scheme produced a bonus pool of £210 million in 2013 which meant that the 87,000 staff enjoyed a bonus equivalent to nine weeks' pay. Since then overall profits have fallen with obvious implications for the profit 'pool'. In 2016, the bonus was the lowest in sixty-three years at 6 per cent of salary (*Guardian*, 2017).

The other example of financially based reward schemes involves the allocation of shares to employees. Here employees have a stake in the organization in the form of shares—not as a short-term reward in itself (as in PRP) but so that they benefit when the company is successful and its share price goes up. There are various types of share ownership schemes, whereby employees:

- are given shares or can buy them;
- buy them as savings with a monthly deduction from salary; or
- are given an option to buy shares at a future time at fixed price.

The CIPD survey (2013) indicated that 25 per cent of organizations operated a scheme of this type, but they are limited to the private sector and to a narrow range of businesses. Evidence of such schemes in the UK suggests that the objective of using share ownership to help generate deeper levels of commitment and engagement is not always achieved as employees may choose to sell their shares and basically 'take the money'. This may be because some of these schemes have been designed primarily to limit the amount of income tax employees are required to pay.

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