

Contingent pay

This chapter starts with a definition of contingent pay and details of its incidence. It then deals with individual contingent pay under the following headings:

- contingent pay as a motivator;
- arguments for and against contingent pay;
- alternatives to contingent pay;
- criteria for success;
- performance-related pay;
- competence-related pay;
- contribution-related pay;
- skill-based pay;
- service-related pay;
- choice of scheme;
- readiness for contribution pay;
- developing and implementing contingent pay.

The chapter concludes with a description of team pay schemes and schemes that pay for organizational performance. Incentives for sales staff and manual workers are covered in Chapter 42.

CONTINGENT PAY DEFINED

Contingent pay provides an answer to the two fundamental reward management questions: what do we value, and what are we prepared to pay for? Individual contingent pay relates financial rewards to the performance, competence, contribution or skill of individual employees. However, pay related to service is also in a sense contingent pay and is therefore considered separately towards the end of the chapter. Contingent pay may also be provided for teams and for organizational performance.

THE INCIDENCE OF CONTINGENT PAY

The e-reward survey of contingent pay (2004b) established that 189 schemes were used by the 100 respondents in the proportions shown in Figure 47.1.

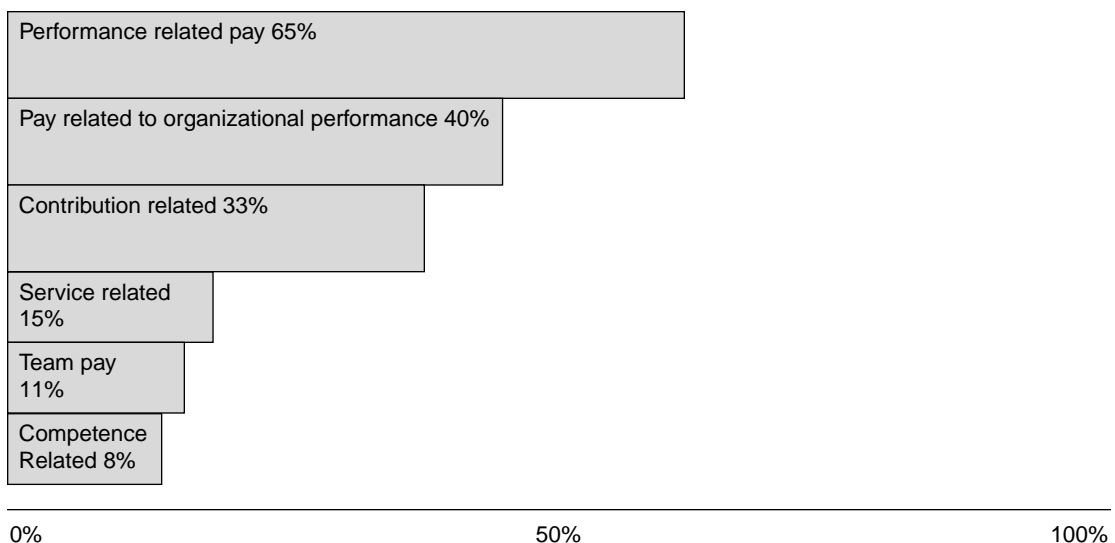


Figure 47.1 Incidence of contingent pay schemes

Performance-related pay remains the most common approach and a large proportion of organizations relate pay to organizational performance. Contribution-related pay (a combination of performance and competence pay) is used to a surprisingly high extent considering that as a defined concept it did not really exist until the end of the 1990s, when it was introduced by Brown and Armstrong (1999). Service-related pay

persists in the public and voluntary sectors, but neither team pay nor competence-related pay is much used.

THE NATURE OF INDIVIDUAL CONTINGENT PAY

Contingent pay may be consolidated in base pay or provided in the form of cash lump sum bonuses. The latter arrangement is called 'variable pay'. This is sometimes referred to as 'pay at risk', which has to be re-earned, as distinct from consolidated pay, which is usually regarded as continuing as long as the person remains in the job and performs it satisfactorily.

Contingent pay schemes are based on processes for measuring or assessing performance, competence, contribution or skill. These may be expressed as ratings, which are converted by means of a formula to a payment. Alternatively, there may be no formal ratings and pay decisions are based on broad assessments rather than a formula.

INDIVIDUAL CONTINGENT PAY AS A MOTIVATOR

Many people see contingent pay as the best way to motivate people. But it is simplistic to assume that it is only the extrinsic motivators in the form of pay that create long-term motivation. The total reward concept, as explained in Chapter 42, emphasizes the importance of non-financial rewards as an integral part of a complete package. The intrinsic motivators, which can arise from the work itself and the working environment, may have a deeper and longer-lasting effect.

Incentives and rewards

When considering contingent pay as a motivator a distinction should be made between financial incentives and rewards.

Financial incentives are designed to provide direct motivation. They tell people how much money they will get in the future if they perform well – 'Do this and you will get that'. A shop floor payment-by-result scheme and a sales representative's commission system are examples of financial incentives.

Financial rewards act as indirect motivators because they provide a tangible means of recognizing achievements, as long as people expect that what they do in the future will produce something worthwhile, as expectancy theory suggests. Rewards can be retrospective – 'You have achieved this, therefore we will pay you that.' But rewards

can also be prospective: 'We will pay you more now because we believe you have reached a level of competence that will produce high levels of performance in the future.'

ARGUMENTS FOR AND AGAINST INDIVIDUAL CONTINGENT PAY

Arguments for

The most powerful argument for individual contingent pay is that those who contribute more should be paid more. It is right and proper to recognize achievement with a financial and therefore tangible reward. This is preferable to paying people just for 'being there', as happens in a service-related system.

The e-reward survey of contingent pay (2004b) found that, in order of importance, the following were the main reasons given by the respondents for using contingent pay:

1. To recognize and reward better performance.
2. To attract and retain high quality people.
3. To improve organizational performance.
4. To focus attention on key results and values.
5. To deliver a message about the importance of performance.
6. To motivate people.
7. To influence behaviour.
8. To support cultural change.

Arguments against

The main arguments against individual contingent pay are that:

- the extent to which contingent pay schemes motivate is questionable – the amounts available for distribution are usually so small that they cannot act as an incentive;
- the requirements for success as set out below are exacting and difficult to achieve;
- money by itself will not result in sustained motivation – as Kohn (1993) points out, money rarely acts in a crude, behaviourist, Pavlov's dog manner;
- people react in widely different ways to any form of motivation – it cannot be assumed that money will motivate all people equally, yet that is the premise on which contribution pay schemes are based;

- financial rewards may possibly motivate those who receive them, but they can demotivate those who don't, and the numbers who are demotivated could be much higher than those who are motivated;
- contingent pay schemes can create more dissatisfaction than satisfaction if they are perceived to be unfair, inadequate or badly managed, and, as explained below, they can be difficult to manage well;
- contingent pay schemes depend on the existence of accurate and reliable methods of measuring performance, competence, contribution or skill, which might not exist;
- contingent pay decisions depend on the judgement of managers which, in the absence of reliable criteria, could be partial, prejudiced, inconsistent or ill-informed;
- the concept of contingent pay is based on the assumption that performance is completely under the control of individuals when in fact, it is affected by the system in which they work;
- contingent pay, especially performance-related pay schemes, can militate against quality and teamwork.

Another powerful argument against contingent pay is that it has proved difficult to manage. Organizations, including the Civil Service, rushed into performance-related pay in the 1980s without really understanding how to make it work. Inevitably problems of implementation arose. Studies such as those conducted by Bowey (1982), Kessler and Purcell (1992), Marsden and Richardson (1994) and Thompson (1992) have all revealed these difficulties. Failures are usually rooted in implementation and operating processes, especially those concerned with performance management, the need for effective communication and involvement, and line management capability.

The last factor is crucial. The success of contingent pay rests largely in the hands of line managers. They have to believe in it as something that will help them as well as the organization. They must also be good at practising the crucial skills of agreeing targets, measuring performance fairly and consistently, and providing feedback to their staff on the outcome of performance management and its impact on pay. Line managers can make or break contingent pay schemes.

Wright (1991) summed it all up: 'Even the most ardent supporters of performance-related pay recognize that it is difficult to manage well', and Oliver (1996) made the point that 'performance pay is beautiful in theory but difficult in practice'.

Conclusions

A comprehensive study by Brown and Armstrong (1999) into the effectiveness of contingent pay as revealed by a number of research projects produced two overall conclusions: 1) contingent pay cannot be endorsed or rejected universally as a principle; and 2) no type of contingent pay is universally successful or unsuccessful. They concluded their analysis of the research findings by stating that 'the research does show that the effectiveness of pay-for-performance schemes is highly context and situation-specific; and it has highlighted the practical problems which many companies have experienced with these schemes'.

ALTERNATIVES TO INDIVIDUAL CONTINGENT PAY

The arguments against contribution pay set out above convince many people that it is unsatisfactory, but what is the alternative? One answer is to rely more on non-financial motivators. But it is still necessary to consider what should be done about pay. The reaction in the 1990s to the adverse criticisms of PRP was to develop the concept of competence-related pay that fitted in well with the emphasis on competencies (the competency industry). This approach, as described later, in theory overcame some of the cruder features of PRP but still created a number of practical difficulties and has never really taken off. In the late 1990s the idea of contribution-related pay emerged, as advocated by Brown and Armstrong (1999). This combines the output-driven focus of PRP with the input (competence) oriented focus of competence-related pay and has proved to be much more appealing than either performance or competence-related pay.

However, many people still have reservations about this approach from the viewpoint of achieving the fair and consistent measurement of contribution. So what are the alternatives for them? Team pay is often advocated because it removes the individualistic aspect of PRP and accords with the belief in the importance of teamwork, but although team pay is attractive, it is often difficult to apply and it still relies on performance measurement.

The traditional alternative is service-related pay, as described later in this chapter. This certainly treats everyone equally (and therefore appeals to trade unions) but pays people simply for being there, and this could be regarded as inequitable in that rewards take no account of relative levels of contribution.

The other common alternative is a spot rate system as described in Chapter 46. Most people, however, want and expect a range of base pay progression, however that is determined, and spot rates are not much used in larger organizations except for senior managers, shop floor and sales staff.

CRITERIA FOR SUCCESS

The following are the success criteria for individual contingent pay:

- Individuals should have a clear line of sight between what they do and what they will get for doing it. A line of sight model adapted from Lawler (1988) is shown in Figure 47.2. The concept expresses the essence of expectancy theory: that motivation only takes place when people expect that their effort and contribution will be rewarded. The reward should be clearly and closely linked to accomplishment or effort – people know what they will get if they achieve defined and agreed targets or standards and can track their performance against them.
- The rewards are worth having.
- Fair and consistent means are available for measuring or assessing performance, competence, contribution or skill.
- People must be able to influence their performance by changing their behaviour and developing their competences and skills.
- The reward should follow as closely as possible the accomplishment that generated it.

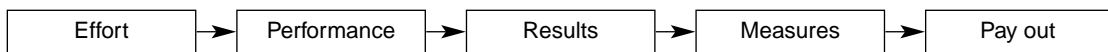


Figure 47.2 Line of sight model

These are ideal requirements and few schemes meet them in full. That is why individual contingent pay arrangements as described below can often promise more than they deliver.

PERFORMANCE-RELATED PAY

Methods of operating PRP vary considerably but its typical main features are summarized in Figure 47.3 and described below.

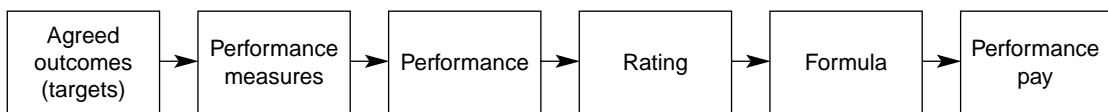


Figure 47.3 Performance-related pay

Basis of scheme

Pay increases are related to the achievement of agreed results defined as targets or outcomes. Scope is provided for consolidated pay progression within pay brackets attached to grades or levels in a graded or career family structure, or zones in a broad-banded structure. Such increases are permanent – they are seldom if ever withdrawn. Alternatively or additionally, high levels of performance or special achievements may be rewarded by cash bonuses, which are not consolidated and have to be re-earned. Individuals may be eligible for such bonuses when they have reached the top of the pay bracket for their grade, or when they are assessed as being fully competent, having completely progressed along their learning curve. The rate of pay for someone who reaches the required level of competence can be aligned to market rates according to the organization's pay policy.

Pay progression

The rate and limits of progression through the pay brackets are typically but not inevitably determined by performance ratings, which are often made at the time of the performance management review but may be made separately in a special pay review. Some organizations do not base PRP increases on formal ratings and instead rely on a general assessment of how much the pay of individuals should increase by reference to performance, potential, the pay levels of their peers and their 'market worth' (the rate of pay it is believed they could earn elsewhere).

Conclusions on PRP

PRP has all the advantages and disadvantages listed for contingent pay. Many people feel the latter outweigh the former. It has attracted a lot of adverse comment, primarily because of the difficulties organizations have met in managing it. Contribution-related pay schemes are becoming much more popular.

COMPETENCE-RELATED PAY

The main features of competence-related pay schemes are illustrated in Figure 47.4 and described below.

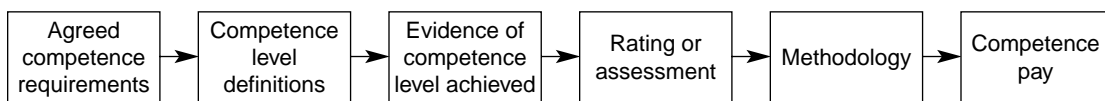


Figure 47.4 Competence-related pay

Basis of scheme

People receive financial rewards in the shape of increases to their base pay by reference to the level of competence they demonstrate in carrying out their roles. It is a method of paying people for the ability to perform now and in the future.

As in the case of PRP, scope is provided for consolidated pay progression within pay brackets attached to grades or levels in a narrow-graded or career family structure, or zones in a broad-banded structure (competence pay is often regarded as a feature of such structures).

Pay progression

The rate and limits of progression through the pay brackets can be based on ratings of competence using a PRP-type matrix, but they may be governed by more general assessments of competence development.

Conclusions on competence-related pay

Competence-related pay is attractive in theory because it can be part of an integrated competency-based approach to HRM. However, the idea of competence-related pay raises two questions. The fundamental question is, 'What are we paying for?' Are we paying for competencies, ie how people behave, or competences, ie what people have to know and be able to do to perform well? If we are rewarding good behaviour (competencies) then a number of difficulties arise. It has been suggested by Sparrow (1996) that these include the performance criteria on which competencies are based, the complex nature of what is being measured, the relevance of the results to the organization, and the problem of measurement. He concluded that 'we should avoid over-egging our ability to test, measure and reward competencies'.

Other fundamental objections to the behavioural approach have been raised by Lawler (1993). He expresses concern about schemes that pay for an individual's personality traits and emphasizes that such plans work best 'when they are tied to the ability of an individual to perform a particular task and when there are valid measures available of how well an individual can perform a task'. He also points out that, 'generic competencies are not only hard to measure, they are not necessarily related to successful task performance in a particular work assignment or work role'.

This raises the second question: 'Are we paying for the possession of competence or the use of competence?' Clearly it must be the latter. But we can only assess the effective use of competence by reference to performance. The focus is therefore on results and if that is the case, competence-related pay begins to look suspiciously like performance-related pay. It can be said that the difference between the two in these

circumstances is all ‘smoke and mirrors’. Competence-related pay could be regarded as no more than a more acceptable name for PRP.

Competence-related pay sounds like a good idea but it has not been taken up to a great extent because of the problems mentioned above.

CONTRIBUTION-RELATED PAY

Contribution-related pay, as modelled in Figures 47.5 and 47.6, is a process for making pay decisions that are based on assessments of both the outcomes of the work carried out by individuals and the inputs in terms of levels of competence and competency that have influenced these outcomes. In other words, it pays not only for what they do but how they do it. Contribution-related pay focuses on what people in organizations are there to do, that is, to contribute by their skill and efforts to the achievement of the purpose of their organization or team.

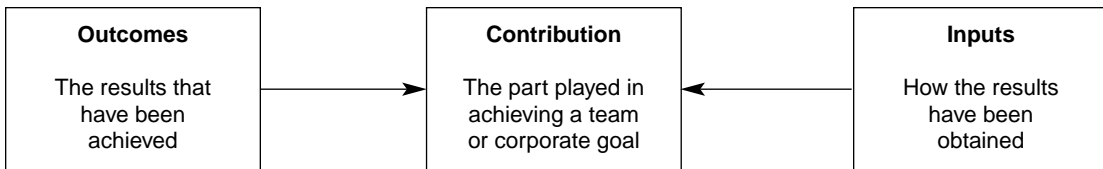


Figure 47.5 Contribution pay model (1)

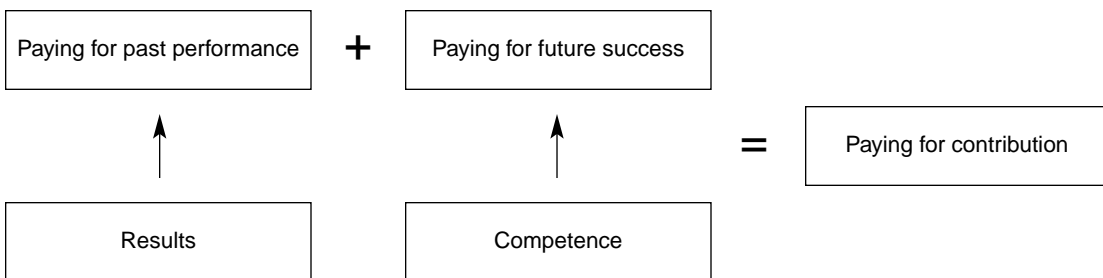


Figure 47.6 Contribution pay model (2)

The case for contribution-related pay was made by Brown and Armstrong (1999) as follows:

Contribution captures the full scope of what people do, the level of skill and competence they apply and the results they achieve, which all contribute to the organization achieving its long-term goals. Contribution pay works by applying the mixed model of performance management: assessing inputs and outputs and coming to a conclusion on the level of pay for people in their roles and their work; both to the organization and in the market; considering both past performance and their future potential.

Main features

Contribution-related pay rewards people for both their performance (outcomes) and their competence (inputs). Pay awards can be made as consolidated pay increases, but in some schemes there is also scope for cash bonuses. The features of contribution-related pay are illustrated in Figure 47.7.

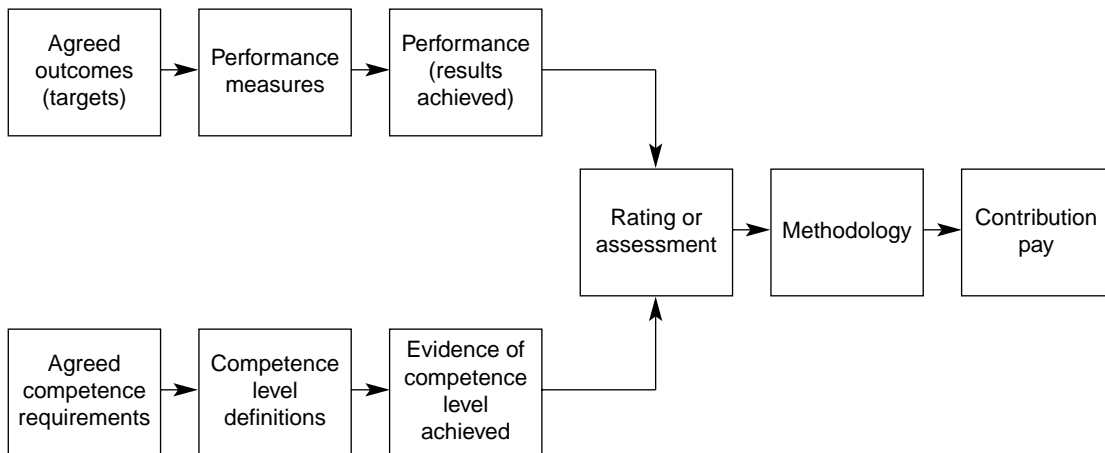


Figure 47.7 Contribution-related pay

A pay for contribution scheme incorporating competence and contribution pay in the form of consolidated increases and cash bonuses developed for the Shaw Trust is modelled in Figure 47.8.

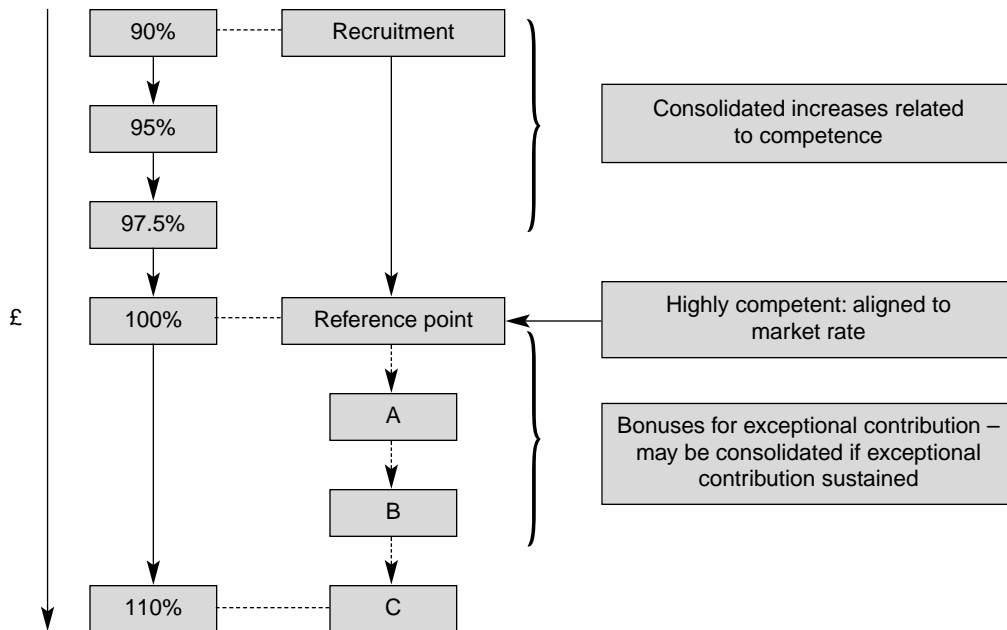


Figure 47.8 Contribution-related pay model (Shaw Trust)

SKILL-BASED PAY

Defined

Skill-based pay provides employees with a direct link between their pay progression and the skills they have acquired and can use effectively. It focuses on what skills the business wants to pay for and what employees must do to demonstrate them. It is therefore a people-based rather than a job-based approach to pay. Rewards are related to the employee's ability to apply a wider range or a higher level of skills to different jobs or tasks. It is not linked simply to the scope of a defined job or a prescribed set of tasks.

A skill may be defined broadly as a learnt ability that improves with practice over time. For skill-based pay purposes the skills must be relevant to the work. Skill-based pay is also known as 'knowledge-based pay', but the terms are used interchangeably, knowledge being regarded loosely as the understanding of how to do a job or certain tasks.

Application

Skill-based pay was originally applied mainly to operatives in manufacturing firms, but it has been extended to technicians and workers in retailing, distribution, catering and other service industries. The broad equivalent of skill-based pay for managerial, professional and administrative staff and knowledge workers is competence-related pay, which refers to expected behaviour as well as, often, to knowledge and skill requirements. There is clearly a strong family resemblance between skill- and competence-related pay – each is concerned with rewarding the person as well as the job. But they can be distinguished both by the way in which they are applied, as described below, and by the criteria used.

Main features

Skill-based pay works as follows:

- Skill blocks or modules are defined. These incorporate individual skills or clusters of skills that workers need to use and which will be rewarded by extra pay when they have been acquired and the employee has demonstrated the ability to use them effectively.
- The skill blocks are arranged in a hierarchy, with natural break points between clearly definable different levels of skills.
- The successful completion of a skill module or skill block will result in an increment in pay. This will define how the pay of individuals can progress as they gain extra skills.
- Methods of verifying that employees have acquired and can use the skills at defined levels are established.
- Arrangements for 'cross-training' are made. These will include learning modules and training programmes for each skill block.

Conclusions

Skill-based pay systems are expensive to introduce and maintain. They require a considerable investment in skill analysis, training and testing. Although in theory a skill-based scheme will pay only for necessary skills, in practice individuals will not be using them all at the same time and some may be used infrequently, if at all. Inevitably, therefore, payroll costs will rise. If this increase is added to the cost of training and certification, the total of additional costs may be considerable. The advocates of skill-based pay claim that their schemes are self-financing because of the resulting increases in productivity and operational efficiency. But there is little

evidence that such is the case. For this reason, skill-based schemes have never been very popular in the UK and some companies have discontinued them.

SERVICE-RELATED PAY

Defined

Service-related pay provides fixed increments that are usually paid annually to people on the basis of continued service either in a job or a grade in a pay spine structure. Increments may be withheld for unacceptable performance (although this is rare) and some structures have a 'merit bar', which limits increments unless a defined level of 'merit' has been achieved. This is the traditional form of contingent pay and is still common in the public and voluntary sectors and in education and the health service, although it has largely been abandoned in the private sector.

Arguments for

Service-related pay is supported by many unions because they perceive it as being fair – everyone is treated equally. It is felt that linking pay to time in the job rather than performance or competence avoids the partial and ill-informed judgements about people that managers are prone to make. Some people believe that the principle of rewarding people for loyalty through continued service is a good one.

Arguments against

The arguments against service-related pay are that:

- it is inequitable in the sense that an equal allocation of pay increases according to service does not recognize the fact that some people will be contributing more than others and should be rewarded accordingly;
- it does not encourage good performance; indeed, it rewards poor performance equally;
- it is based on the assumption that performance improves with experience, but this is not automatically the case – it has been said that a person with five years' experience may in practice only have had one year's experience repeated five times;
- it can be expensive – everyone may drift to the top of the scale, especially in times of low staff turnover, but the cost of their pay is not justified by the added value they provide.

The arguments against service-related pay have convinced most managements, although some are concerned about managing any other form of contingent-pay schemes (incremental pay scales do not need to be managed at all). They may also have to face strong resistance from their unions and can be unsure of what exit strategy they should adopt if they want to change. They may therefore stick with the *status quo*.

CHOICE OF APPROACH

The first choice is whether or not to have contingent pay related to performance, competence, contribution or skill. Public or voluntary sector organizations with fixed incremental systems (pay spines), where progression is solely based on service, may want to retain them because they do not depend on possibly biased judgements by managers and they are perceived as being fair – everyone gets the same – and easily managed. However, the fairness of such systems can be questioned. Is it fair for a poor performer to be paid more than a good performer simply for being there?

The alternatives to fixed increments are either spot rates or some form of contingent pay. Spot rate systems in their purest form are generally only used for senior managers, shop floor or retail workers, and in smaller organizations and new businesses where the need for formal practices has not yet been recognized.

If it is decided that a more formal type of contingent pay for individuals should be adopted, the choice is between the various types of performance pay, competence-related or contribution-related pay and skill-based pay, as summarized in Table 47.1. The alternative to individual contingent pay is team pay, as described later. Pay related to organizational performance is another alternative, although some organizations have such schemes in addition to individual contingent pay.

READINESS FOR INDIVIDUAL CONTINGENT PAY

The 10 questions to be answered when assessing readiness for individual contingent pay are:

1. Is it believed that contingent pay will benefit the organization in the sense of enhancing its ability to achieve its strategic goals?
2. Are there valid and reliable means of measuring performance?
3. Is there a competency framework and are there methods of assessing levels of competency objectively (or could such a framework be readily developed)?

Table 47.1 Comparison of individual contingent pay schemes

Type of scheme	Main features	Advantages	Disadvantages	When appropriate
Performance-related pay	Increases to basic pay or bonuses are related to assessment of performance	May motivate (but this is uncertain) Links rewards to objectives Meets the need to be rewarded for achievement Delivers message that good performance is important and will be rewarded	May <i>not</i> motivate Relies on judgements of performance which may be subjective Prejudicial to teamwork Focuses on outputs, not quality Relies on good performance management processes Difficult to manage well	For people who are likely to be motivated by money In organizations with a performance-orientated culture When performance can be measured objectively
Competence-related pay	Pay increases are related to the level of competence	Focus attention on need to achieve higher levels of competence Encourages competence development Can be integrated with other applications of competency-based HR management	Assessment of competence levels may be difficult Ignores outputs – danger of paying for competences that will not be used Relies on well-trained and committed line managers	As part of an integrated approach to HRM where competencies are used across a number of activities Where competence is a key factor where it may be inappropriate or hard to measure outputs Where well-established competency frameworks exist

continued

Table 47.1 *continued*

Type of scheme	Main features	Advantages	Disadvantages	When appropriate
Contribution-related pay	Increases in pay or bonuses are related both to inputs (competence) and outputs (performance)	Rewards people not only for what they do but how they do it	As for both PRP and competence-related pay – it may be hard to measure contribution and it is difficult to manage well	When it is believed that a well-rounded approach covering both inputs and outputs is appropriate
Skill-based pay	Increments related to the acquisition of skills	Encourages and rewards the acquisition of skills	Can be expensive when people are paid for skills they don't use	On the shop floor or in retail organizations
Service-related pay	Increments related to service in grade	No scope for bias, easy to manage	Fails to reward those who contribute more	Where this is the traditional approach and trade unions oppose alternatives

4. Are there effective performance management processes that line managers believe in and carry out conscientiously?
5. Are line managers willing to assess performance or contribution and capable of doing so?
6. Are line managers capable of making and communicating contingent pay decisions?
7. Is the HR function capable of providing advice and guidance to line managers on managing contingent pay?
8. Can procedures be developed to ensure fairness and consistency in assessments and pay decisions?
9. Are employees and trade unions willing to accept the scheme?
10. Do employees trust management to deliver the deal?

DEVELOPING AND IMPLEMENTING INDIVIDUAL CONTINGENT PAY

The 10 steps required to develop and implement individual contingent pay are:

1. Analyse culture, strategy and existing processes, including the grade and pay structure, performance management and methods of progressing pay or awarding cash bonuses.
2. Decide which form of contingent pay is most appropriate.
3. Set out aims that demonstrate how contribution pay will help to achieve the organization's strategic goals.
4. Communicate aims to line managers' staff and involve them in the development of the scheme.
5. Determine how the scheme will operate.
6. Develop or improve performance management processes covering the selection of performance measures, decisions on competence requirements, methods of agreeing objectives and the procedure for conducting joint reviews.
7. Communicate intentions to line managers and staff.
8. Pilot test the scheme and amend as necessary.
9. Provide training to all concerned.
10. Launch the scheme and evaluate its effectiveness after the first review.

TEAM-BASED PAY

Team-based pay provides rewards to teams or groups of employees carrying out similar and related work that is linked to the performance of the team. Performance may be measured in terms of outputs and/or the achievement of service delivery standards. The quality of the output and the opinion of customers about service levels are also often taken into account.

As described by Armstrong and Ryden (1996), team pay is usually paid in the form of a bonus that is shared amongst team members in proportion to their base rate of pay (much less frequently, it is shared equally). Individual team members may be eligible for competence-related or skill-based pay but not for performance-related pay.

Advantages of team pay

Team pay can:

- encourage effective teamworking and co-operative behaviour;

- clarify team goals and priorities;
- enhance flexible working within teams;
- encourage multiskilling;
- provide an incentive for the team collectively to improve performance;
- encourage less effective team members to improve to meet team standards.

Disadvantages of team pay

The disadvantages of team pay are that:

- it only works in cohesive and mature teams;
- individuals may resent the fact that their own efforts are not rewarded specifically;
- peer pressure, which compels individuals to conform to group norms, could be undesirable.

Conditions suitable for team pay

Team pay is more likely to be appropriate when:

- teams can be readily identified and defined;
- teams are well established;
- the work carried out by team members is interrelated – team performance depends on the collective efforts of team members;
- targets and standards of performance can be determined and agreed readily with team members;
- acceptable measurements of team performance compared with targets and standards are available;
- generally, the formula for team pay meets the criteria for performance pay.

ORGANIZATION-WIDE SCHEMES

Organization-wide bonus schemes pay sums of money to employees that are related to company or plant-wide performance. They are designed to share the company's prosperity with its employees and thus to increase their commitment to its objectives and values. Because they do not relate reward directly to individual effort, they are not effective as direct motivators, although gain-sharing schemes can focus directly on what needs to be done to improve performance and so get employees involved in productivity improvement or cost-reduction plans. The two main types of schemes are gain sharing and profit sharing.

Gain sharing

Gain sharing is a formula-based company or factory-wide bonus plan that provides for employees to share in the financial gains resulting from increases in added value or another measure of productivity. The link between their efforts and the payout can usefully be made explicit by involving them in analysing results and identifying areas for improvement.

Profit sharing

Profit sharing is the payment to eligible employees of sums in the form of cash or shares related to the profits of the business. The amount shared may be determined by a published or unpublished formula or entirely at the discretion of management. Profit sharing differs from gain sharing in that the former is based on more than improved productivity. A number of factors outside the individual employee's control contribute to profit. Gain sharing aims to relate its payouts much more specifically to productivity and performance improvements within the control of employees. It is not possible to use profit-sharing schemes as direct incentives as for most employees the link between individual effort and the reward is so remote. But they can increase identification with the company and many managements operate profit-sharing schemes because they believe that they should share the company's success with its employees.

Share ownership schemes

There are two main forms of share ownership plans: Share Incentive Plans (SIPS) and Save-As-You-Earn (SAYE) schemes. These can be Inland Revenue-approved and if so, produce tax advantages as well as linking financial rewards in the longer term to the prosperity of the company.

Share incentive plans

Share incentive plans must be Inland Revenue-approved. They provide employees with a tax-efficient way of purchasing shares in their organization to which the employer can add 'free', 'partnership' or 'matching' shares and which can also be issued as shares. There is a limit to the amount of free shares that can be provided to employees (£3,000 a year in 2004). Employees can use up to £1,500 a year (in 2004) out of pre-tax and pre-National Insurance Contributions pay to buy partnership shares, and employers can give matching shares at a ratio of up to two matching shares for each partnership share.

Save-As-You-Earn schemes

SAYE schemes must be Inland Revenue-approved. They provide employees with the option to buy shares in the company in three, five or seven years' time at today's price, or a discount of up to 20 per cent of that price. Purchases are made from a savings account to which the employee pays an agreed sum each month. The monthly savings must be between £5 and £250. Income tax is not chargeable when the option is granted.