50 Contingent Pay

Key concepts and terms

- Bonus
- Contingent pay
- Incentives
- Rewards
- Variable pay
- Competency-related pay
- Contribution-related pay
- Performance-related pay
- Skills-based pay

Learning outcomes

On completing this chapter you should be able to define these key concepts. You should also know about:

- The basis of contingent pay
- Arguments for contingent pay
- Alternatives to contingent pay
- Types of individual contingent pay
- Developing and implementing individual contingent pay
- Bonus schemes
- Organization-wide bonus schemes
- Contingent pay as a motivator
- Argument against contingent pay
- Criteria for success
- Readiness for individual contingent pay
- Service-related pay
- Team pay
- Choice of approach

Introduction

The term 'contingent pay' is used in this chapter to describe any formal pay scheme that provides for payments on top of the base rate, which are linked to the performance, competency, contribution or skill of people. Contingent pay can apply to individuals (individual contingent pay) or teams, or it can operate on an organization-wide basis. It is either consolidated in the base rate so that pay progresses within a pay range or it is paid as a non-consolidated cash bonus (the latter arrangement is called 'variable pay').

Pay can be related to service. This is dealt with in this chapter, but it is not regarded as contingent pay in the sense defined above as it does not relate to performance, contribution, competency or skill. The comments made about contingent pay as a motivator and the advantages and disadvantages of contingent pay do not therefore apply to pay related to service.

Contingent pay is concerned with answering the two fundamental reward management questions: what do we value? What are we prepared to pay for? Contingent pay schemes are based on measurements or assessments. These may be expressed as ratings that 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.

This chapter examines contingent pay as a motivator, its advantages and disadvantages, and criteria for success. It then describes the different forms of contingent pay and how to choose and develop them. Incentives for sales staff and manual workers are covered in Chapter 51.

Contingent pay as a motivator

Many people see pay related to performance, competency, contribution or skill 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 46, emphasizes the importance of non-financial rewards as an integral part of a complete package. The intrinsic motivators that 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-results scheme or 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 competency that will produce high levels of performance in the future.'

Arguments for and against contingent pay

Arguments for

The most powerful argument for 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. Other typical arguments in favour of using contingent pay are set out below.

SOURCE REVIEW

Reasons in order of importance for using contingent pay given by respondents to the e-reward 2004 survey

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 that 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, competency, 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.

A number of commentators have argued forcibly against contingent pay, especially in the form of performance-related pay. Two of the most prominent have been Alfie Kohn and Jeffrey Pfeffer.

Kohn (1993) contended that financial rewards 'do not create lasting satisfaction; they merely and temporarily change what we do… rewards, like punishment, may actually undermine the intrinsic motivation that results in optimal performance'. Pfeffer (1998b) listed in the *Harvard Business Review* his fifth and sixth myths of pay as follows:

> Myth # 5: Individual incentive pay improves performance. Reality: Individual incentive pay, in reality, undermines performance of both the individual and the organization. Many studies strongly suggest that this form of reward undermines teamwork, encourages a short-term focus, and leads people to believe that pay is not related to performance at all but to having the 'right' relationships and an ingratiating personality.
>
> Myth # 6: People work for money. Reality: People do work for money – but they work even more for meaning in their lives. In fact, they work to have fun. Companies that ignore this fact are essentially bribing their employees and will pay the price in a lack of loyalty and commitment.

Another powerful argument against contingent pay is that it has proved difficult to manage. Organizations, including the Civil Service, rushed into performance-related pay (PRP) 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 (1992a, 1992b) 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) has 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 on the effectiveness of contingent pay

A 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 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 competency-related pay, which fitted in well with the emphasis on competencies. 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 (competency) oriented focus of competency-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? 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 49. Most people, though, 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

In spite of the powerful arguments against contingent pay, many organizations and the people who work in them feel that it is right and proper that people who contribute more should be paid more. But to be 'right and proper' the process for deciding on who gets contingent pay when it is paid to individuals and teams and how much they get should be fair, consistent and in accordance with the principles of distributive justice, ie that people feel that they have been treated justly, that rewards have been distributed in accordance with their contribution, that they receive what was promised to them and they get what they need.

These are exacting criteria. If the objective is to make contingent pay an incentive, the criteria are even more exacting. These are as follows:

1. Individuals should have a clear line of sight between what they do and what they will get for doing it (see Figure 50.1). This 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.
2. Rewards are worth having.
3. Fair and consistent means are available for measuring or assessing performance, competence, contribution or skill.
4. People must be able to influence their performance by changing their behaviour and developing their competences and skills.
5. The reward should follow as closely as possible the accomplishment that generated it.

Figure 50.1 Line of sight model

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

Performance-related pay

Methods of operating performance-related pay (PRP) vary considerably, but its typical features are summarized in Figure 50.2 and described below.

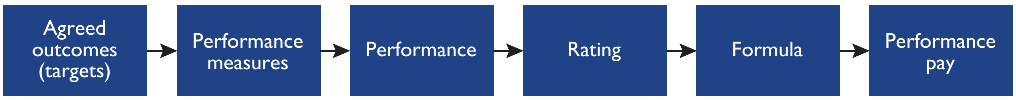

Figure 50.2 Performance-related pay

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 that 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 pay ranges or brackets are typically but not inevitably determined by performance ratings that are often made at the time of the performance management review but may be made separately in a special pay review. The e-reward 2004 survey found that the average increase was 3.9 per cent.

A formula in the shape of a pay matrix is often used to decide on the size of increases. This indicates the percentage increase payable for different performance ratings according to the position of the individual's pay in the pay range (see also Chapter 53).

Pay progression in a graded structure is typically planned to decelerate through the grade for two reasons. First, it is argued in line with learning curve theory, that pay increases should be higher during the earlier period in a job when learning is at its highest rate. Second, it may be assumed that the central or reference point in a grade represents the market value of fully competent people. According to the pay policy of the organization, this may be at or higher than the median. Especially in the latter case, it may be believed that employees should progress quite quickly to that level but, beyond it, they are already being paid well and their pay need not increase so rapidly. This notion may be reasonable, but it can be difficult to explain to someone why they get smaller percentage increases when they are performing well at the upper end of their scale.

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 more popular.

Competency-related pay

The main features of competency-related pay schemes are illustrated in Figure 50.3 and described below.

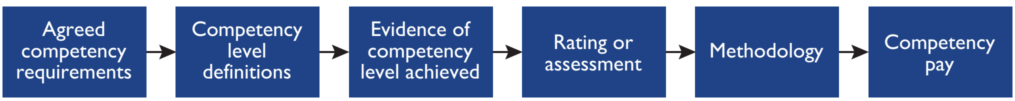

Figure 50.3 Competency-related pay

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 (competency 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 competency using a pay matrix, but they may be governed by more general assessments of competency development.

Conclusions on competency-related pay

Competency-related pay is attractive in theory because it can be part of an integrated competency-based approach to HRM. However, the idea of competency-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 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 competencies?' 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, competency-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'. Competency-related pay could be regarded as a more acceptable name for PRP. Competency-related pay sounds like a good idea but it has never been taken up to a great extent because of the problems mentioned above.

Contribution-related pay

Contribution-related pay, as modelled in Figures 50.4 and 50.5, is a process for making pay decisions based on assessments of both the outcomes of the work carried out by individuals and the inputs in terms of levels of 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.

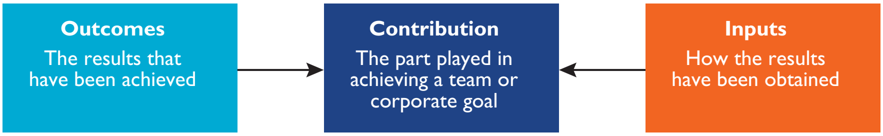

Figure 50.4 Contribution pay model (1)

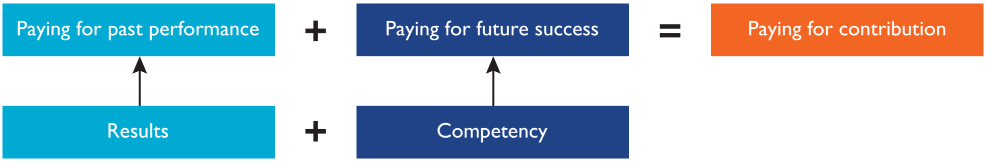

Figure 50.5 Contribution pay model (2)

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

SOURCE REVIEW

The case for contribution-related pay, Brown and Armstrong (1999)

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 competency (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 50.6.

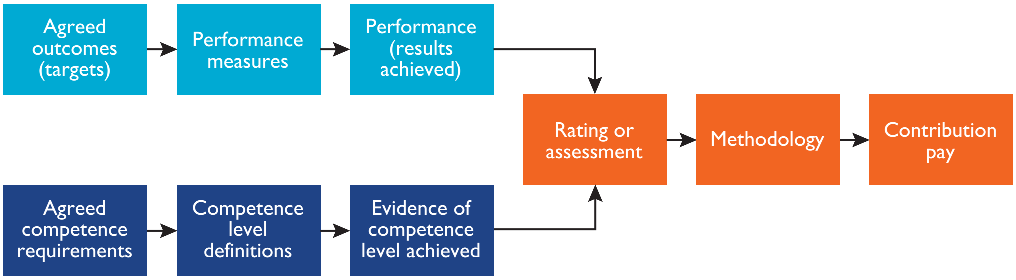

Figure 50.6 Contribution-related pay

A 'pay for contribution' scheme incorporating consolidated increases and cash bonuses developed for the Shaw Trust is modelled in Figure 50.7.

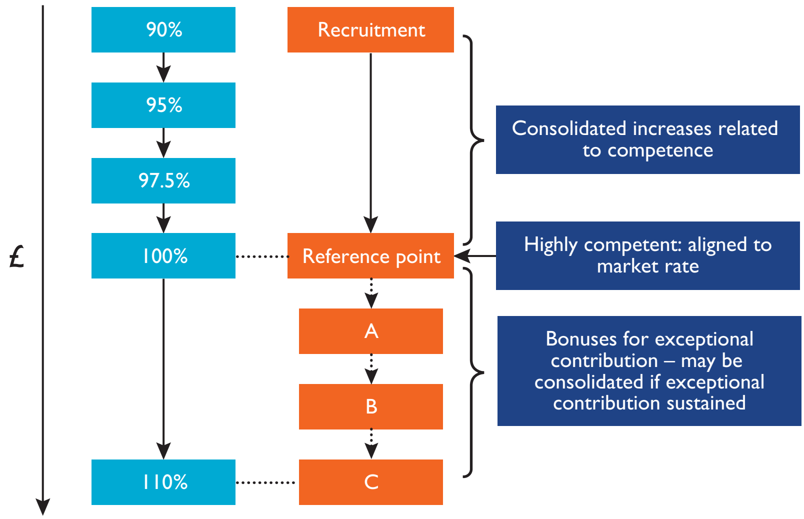

Figure 50.7 Contribution-related pay model

Skill-based pay

Definition

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 with 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 in 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.

Readiness for individual contingent pay

The 10 questions to be answered when assessing readiness for pay related to performance, competency, contribution or skill 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)?
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

If it is decided to use individual contingent pay, the 10 steps required are as follows.

Developing and implementing individual contingent pay

1. Assess readiness.
2. Analyse culture, strategy and existing processes, including the grade and pay structure, performance management and methods of progressing pay or awarding cash bonuses.
3. Decide which form of contingent pay is most appropriate.
4. Set out aims that demonstrate how contribution pay will help to achieve the organization's strategic goals.
5. Communicate aims to line managers and staff and involve them in the development of the scheme.
6. Determine how the scheme will operate.
7. 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.
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.

Service-related pay

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' that 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. It is also easy to manage; in fact, it does not need to be managed at all.

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 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 organizations, although some are concerned about managing any other form of contingent-pay schemes. 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.

Summary of individual contingent pay schemes

The features, advantages, disadvantages and the appropriateness of individual contingent pay schemes and service-related pay are set out in Table 50.1.

Bonus schemes

Bonus schemes provide cash payments to employees that are related to the performance of themselves, their organization or their team, or a combination of two or more of these. Bonuses are often referred to as 'variable pay' or 'pay-at-risk'.

A defining characteristic of a bonus is that it is not consolidated into base pay. It has to be re-earned, unlike increases arising from individual contingent pay schemes such as performance or contribution-related pay or pay related to service, which are consolidated. Such payments have been described as 'gifts that go on giving' on the grounds that a reward for, say, one year's performance is continued in subsequent years even if the level of performance has not been sustained.

Table 50.1 Summary of contingent pay and service-related 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 not 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-oriented culture • When performance can be measured objectively
Competency-related pay	Pay increases are related to the level of competence	• Focuses 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

Table 50.1 *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 a traditional approach and trade unions oppose alternatives

Cash bonuses may be the sole method of providing people with rewards in addition to their base pay, or they may be paid on top of individual contingent pay. 'Combination' bonus schemes combine schemes for rewarding individual performance with those for rewarding either team or organizational performance.

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.

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 and disadvantages of team pay

Advantages of team pay:

- Encourages effective team working and cooperative behaviour.
- Clarifies team goals and priorities.
- Enhances flexible working within teams.
- Encourages multi-skilling.
- Provides an incentive for the team collectively to improve performance.
- Encourages less effective team members to improve to meet team standards.

Disadvantages of team pay:

- It only works in cohesive and mature teams.
- Individuals may resent the fact that their own efforts are not rewarded specifically.
- Peer pressure that 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 bonus 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 gainsharing 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 gainsharing and profit sharing.

Gainsharing

Gainsharing 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 gainsharing in that the former is based on more than improved productivity. A number of factors outside the individual employee's control contribute to profit, while gainsharing 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 organizations operate profit sharing schemes because the management believes that it 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 HMRC-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 HMRC-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.

Save-as-you-earn schemes

Save-as-you-earn schemes must be HMRC-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 from which the employee pays an agreed sum each month. Income tax is not chargeable when the option is granted.

Choice of approach to contingent pay

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 alternative to fixed increments is 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, competency-related or contribution-related pay and skill-based pay, as summarized in Table 50.1. The alternative to individual contingent pay is team pay. Pay related to organizational performance is another alternative, although some organizations have such schemes in addition to individual contingent pay. Bonuses may be paid in addition to or as an alternative to consolidated pay, and individual bonuses can be combined with team or organizational bonus schemes.

Contingent pay – key learning points

The basis of contingent pay

Contingent pay is concerned with answering the two fundamental reward management questions: 1) What do we value? 2) What are we prepared to pay for? Schemes are based on measurements or assessments.

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 emphasizes the importance of non-financial rewards as an integral part of a complete package.

Argument for contingent pay

The most powerful argument for contingent pay is that those who contribute more should be paid more.

Arguments against contingent pay

The main arguments against contingent pay are: 1) 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, 2) the requirements for success are exacting and difficult to achieve, and 3) money by itself will not result in sustained motivation.

Alternatives to contingent pay

Service-related pay or spot rates.

Criteria for success

Individuals should have a clear line of sight between what they do and what they will get for doing it; 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; and the reward should follow as closely as possible the accomplishment that generated it.

Types of individual contingent pay

A summary of contingent pay schemes is given in Table 50.1.

Assess readiness

Consider the extent to which contingent pay will benefit the organization, can be based on reliable methods of measuring performance and/or competency, can be managed effectively (by line managers and HR), will be accepted by trade unions and employees.

Contingent pay – key learning points (continued)

Developing and implementing individual contingent pay

Assess readiness, analyse requirements, decide on most appropriate approach, define aims, communicate aims, design scheme, development assessment processes, pilot-test, provide training, and launch and evaluate the scheme.

Service-related pay

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.

Bonus schemes

Bonus schemes provide cash payments to employees that are related to the performance of themselves, their organization or their team, or a combination of two or more of these. Bonuses are often referred to as 'variable pay' or 'pay-at-risk'.

Team 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.

Organization-wide bonus schemes

These include profit sharing, gainsharing and employee share schemes.

Choice of approach

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, competency-related or contribution-related pay and skill-based pay. The alternative to individual contingent pay is team pay. Pay related to organizational performance is another alternative, although some organizations have such schemes in addition to individual contingent pay. Bonuses may be paid in addition to or as an alternative to consolidated pay, and individual bonuses can be combined with team or organizational bonus schemes.

Questions

1. Thompson (1998) commented that: 'Research on the efficacy of performance pay in delivering higher trust, commitment and motivation tends to suggest that at best individual performance-related pay is neutral in its effects and at worst highly destructive.' Give your reactions to this statement based on your own experience or understanding of the impact of performance pay.
2. You have been asked to talk for 30 minutes or so to a group of first-year business management students at your local university about the arguments for and against performance-related pay. Prepare an outline of your talk, which should incorporate evidence from research or experience to support your case.
3. From a senior colleague: 'I don't believe that our performance-related pay scheme is working. I have just been involved in updating our competency framework and I have heard that such frameworks are being used by other organizations as the basis for pay related to competency. What do you think of this idea? I would be interested in any evidence you can produce to support your views.'
4. From your chief executive: 'Everyone extols the virtues of teams and there seem to be many good arguments against individual performance pay. We have many well-established teams and we believe in good teamwork. What is the business case for team pay? Are there any reasons why we should not follow that route?'

References

Bowey, A (1982) *The Effects of Incentive Pay Systems*, Department of Employment, Research Paper No 36, DOE, London

Brown, D and Armstrong, M (1999) *Paying for Contribution*, Kogan Page, London

e-reward (2004) *Survey of Contingent Pay*, e-reward.co.uk, Stockport

Kessler, J and Purcell, J (1992) Performance-related pay: objectives and application, *Human Resource Management Journal*, **2** (3), pp 16–33

Kohn, A (1993) Why incentive plans cannot work, *Harvard Business Review*, September–October, pp 54–63

Lawler, E E (1993) Who uses skill-based pay, and why, *Compensation & Benefits Review,* March–April, pp 22–26

Marsden, D and Richardson, R (1994) Performing for pay?, *British Journal of Industrial Relations*, **32**,(2), pp 243–61

Oliver, J (1996) Cash on delivery, *Management Today*, August, pp 6–9

Pfeffer, J (1998b) Six dangerous myths about pay, *Harvard Business Review*, May/June, pp 109–19

Sparrow, P R (1996) Too true to be good, *People Management*, December, pp 22–27

Thompson, M (1992a) *Pay and Performance: The employee experience*, Institute of Manpower Studies, Brighton

Thompson, M (1992b) *Pay and Performance: The employer experience*, Institute of Manpower Studies, Brighton

Thompson, M (1998) Trust and reward, in (eds) S Perkins and St John Sandringham, *Trust, Motivation and Commitment: A reader*, Strategic Remuneration Research Centre, Faringdon

Wright, V (1991) Performance-related pay, in (ed) F Neale, *The Handbook of Performance Management*, IPM, London