

A fair days pay

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How to tailor pay to performance THE way companies pay people says a lot about how they see their business. “Compensation policy is central to supporting the company culture,” says Albert Knab, head of compensation and benefits at the Stuttgart offices of DaimlerChrysler, a company going through a spectacular culture change of its own. Many companies, though, have begun to use pay policy more actively. “Compensation strategy has become central to many company’s businesses,” says Richard Walker, who recently wrote a report on “Motivating and Rewarding Managers” for the EIU, a sister company of *The Economist*. Firms have become, he says, “concerned less about acquiring physical resources and more about how their human resources can efficiently exploit them.”

Put this new emphasis on people as assets together with the downward pressure on costs, and employers face an obvious difficulty. They hope to get round it by using pay much more flexibly. Instead of “performance-related” pay—too formulaic—the new mantra is “variable” pay: bonuses linked to the performance of the individual, the team or the company; and stock options (which are dealt with in the next chapter).

In America, pay variability has been increasing for some years. “The average pay increase in organisation probably hasn’t changed in 20 years,” reckons Mark Huselid, professor of human-resources management at Rutgers, the state university of New Jersey. “But the variance has.” Variable pay is now advancing in other countries too, and covering a much wider range of workers than before. “We are extending variable pay to more and more functions, and offering specific rewards for targeted achievements,” says Eckart Reimers, head of human relations at IBM in Stuttgart. “German managers find this unusual—although it is less unusual than it was.”

The main reason is often the need to hold down costs. “It’s interesting that variable pay has spread in Europe at a time when inflation is at its lowest level for 30 years,” says Brian Dive, in charge of remuneration at Unilever. “It makes sense, because if your results aren’t good or your people don’t perform, you don’t have to pay them.” And indeed, one of the most useful effects of variable pay is to pass some of the risks of running a business to the employees. If profits fall, so will profit-linked bonuses. But that is not the only reason for the spread of flexibility. It also reflects a recognition by many employers that they depend more than ever on a relatively small group of excellent people; and that they need to strive constantly to increase the productivity of all their workers.

An example is Levi Strauss, one of the most famous names in the clothing business. Last year, records Steve Epstein, Levi’s head of remuneration, the company went through something of a revolution. Its jeans were being squeezed off the shelves by rival brands. “In the past,” recalls Mr Epstein in Levi’s elegant converted Ice House on San Francisco’s waterfront, “we brought in people with sales experience, and they stayed until they retired. We had thousands of resumes for every job. When you’re that successful, you don’t have to market yourself—and we could pay everyone pretty much the same.” Lulled by its fame, Levi grew complacent.

“Now our strategy has shifted, to differentiating performance. We need incentive payments that can compete.” That is a tall order for a company fishing in the same talent pool as the heavy-weights of Silicon Valley: Levi is privately held, so cannot offer stock options. But harder

still has been the blow to its egalitarian corporate culture from having to acknowledge that 20% of the staff probably generate 80% of the profits. “We now focus more on paying the person, not paying the job,” says Mr Epstein.

That change is making it easier to attract bright recruits from Generation X —the 20- and 30-somethings who bring not just a fresh eye but also a different attitude to pay and to work. Partly to accommodate them, the company ditched its old bonus plan, 80% of which automatically went to everybody. Instead, last year it introduced a new scheme, most of which goes to reward individual performance. A streak of the old culture remains: the company is shifting the decision on who gets what from individual managers to management committees to depoliticise the process. The upshot, reckons Mr Epstein, will be smallish across-the-board pay increases for most people. If the bulk of the workforce got, say, 3%, then people with critical skills might get 5-6% and a few rising stars even more.

The change at Levi is being echoed all over the world. It emerges in study after study by pay consultants and academics. According to Richard Meisheid of Towers Perrin, a consultancy that conducts an annual worldwide survey of compensation, “There is still a global trend away from programmes that reward tenure to those that allow more flexibility.” The principle of variable pay is being adopted even by employers not generally noted for bold management. In Britain, for instance, the Bank of England now puts nearly 10% of its wage bill aside for good-performance bonuses; and the government has floated the idea of rewarding doctors according to their success in treating patients (which, if adopted, might ensure that prudent doctors treat only the fit). In the United States, says Henry Romero of the Office of Personnel Management, federal agencies are becoming keen to pay for performance, roused from complacency partly by the difficulty of keeping computer experts needed to stamp out the millennium bug in their elderly systems.

A better kind of carrot

Variable pay gives employers the elbow room to hire computer nerds at inflated rates. But does the promise of a bonus really make people work harder—or better? The answer, says David Guest, a human-resources expert at London University’s Birkbeck College, is: “Only if you line up several parts of the package, and not just pay.” Mr Huselid agrees. “The fear is not that incentive pay doesn’t work—but that it works so well that companies have to be careful about the incentives they create. Incentive pay should be the very last thing you do, once you have got your strategy right and understand your business.” It is easy to get even simple incentives wrong—as when AT&T paid computer programmers by the number of lines of code they produced, or when British life insurers rewarded agents for the number of pensions they sold, whether they were suitable for the buyer or not.

In fact, most studies* on the impact of incentives have looked at simple tasks. One, by Edward Lazear of Stanford University Business School, found that workers installing car windscreens increased their productivity when they were put on piece rates rather than on fixed wages. A study of British jockeys suggested they were more likely to win if they were paid out of prize money than if they were kept on retainer. A review of farm workers in the Philippines found that those on piece rates lost more weight at work than those on fixed pay, so probably expended more effort (but they also made more money and could afford to buy more food). None of this, though, is much help in dealing with the complexities faced by big employers.

Thus, for some workers, it may be easy to set goals: in a call centre, for instance, sales people can be rewarded for the amount they sell. But what would be the right incentives for their colleagues taking incoming calls? What should be measured, effort or performance? The individual or the team? The qualities companies want to reward are often the ones that are hardest to quantify, such as collaboration and judgment. Yet goals need to be simple—employees need to see a clear connection between the way they and their team work and the incentive. “The pay seems to have less of an impact than the goal-setting,” claims a sceptical l

Guest. "So why waste money on pay—especially when it almost always seems unfair?"

Some companies go to great lengths to devise a performance assessment that will seem fair. One of the most elaborate is that of Allstate, a Chicago-based insurance group recently spun off from Sears. The company has clearly not abandoned an old-fashioned admiration for durability: Thomas Tippet, the vice-president of human resources, is one of several managers with a plaque on his door testifying to "30 years of service". But the company has also, for example, created a "leadership index", based on an anonymous survey of how a manager's underlings rate his performance, which determines some 15% of his annual incentive bonus. Mr Tippet reports that this was not very popular at first. Creating a performance-management system which, as Mr Tippet infelicitously puts it, "would distinct out the top performers" is proving even harder, but already the very best can earn roughly twice as much as the average.

Companies frequently combine several different schemes to reward different kinds of achievement. Eddie Bauer, a clothing retailer, used to pay people mainly by the kind of job they did, not by how they did it. "People knew they could change their pay by rewriting their job description, not by raising their productivity," says Lori Fosnes, the senior compensation manager. Now staff fit into one of three bands: entry, intermediate or specialist. They can win more pay by being promoted—sideways as well as upwards, as long as they acquire new skills in the process—or by improving their personal performance. But even if they thus qualify for a bonus, they receive it only if the whole company does well. "Last year, the company failed to hit the hurdle," says Ms Fosnes. "So there were no pay-outs, even for performance. That was a hard message to give."

However, the company reinforces the message with something that makes it easier to reward teamwork: an elaborate array of prizes for good behaviour. The most basic is a star, about four inches across, which can be stuck on a filing cabinet or a wall. It can be given by any "associate", as Bauer people call each other, to any other at any time, in recognition for doing something well. The Oscar of Bauer awards is the "Best of Bauer", decided by a "legends" committee and handed out at a ceremony in March. Employees who receive this accolade wear a special name tag all year.

Such schemes may sound like kindergarten. But Bauer's human-resources staff think they have a powerful effect because they are so much more public than pay rises. (A recent survey by Towers Perrin pointed in the same direction; see chart 5.) They also point to other aspects of a job that individuals find rewarding: does their office have a window? Do they have a parking space? Can they work from home? Such things can be immensely effective in rewarding good performance, and generally cost a lot less than a pay rise.

Pay alone rarely keeps people with an employer. In the war for talent, companies need better weapons than cash. They need to guarantee their stars a sequence of fascinating jobs; to give them a sense of belonging; and to tell them they are tops, says Ed Michaels of McKinsey, a consultancy.

If cash is only one of many things that make ordinary workers run, what does it take to motivate their bosses? That question is currently being tested to destruction in the United States, by biggest performance-related pay deals in history.

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