Paying for Performance

Incentive Pay Schemes and Employees' Financial Participation

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Executive Summary

In recent decades, the compensation packages of a growing proportion of firms include pay schemes that are linked to employee or company performance. By motivating individual workers to be more efficient at work and increasing their attachment and identification with the interests of the enterprise, incentive schemes are expected to improve interpersonal relationships, raise job satisfaction, lower absenteeism and waste of intermediate material or capital, and lower turnover rates, all of which should produce lasting effect on company performance.

Most firms that use pay for performance systems do not introduce them by themselves but rather as part of changes in work organisation such as team work, employee involvement committees, or total quality management that offer employees a greater role in decision-making.

While there has been a lot of research done in recent years on the economic effects of incentive schemes, little is known about the patterns of performance related pay both within and across countries. Available studies suggest that when firms have good performance measures, performance related pay is associated with improved employee productivity and better quality of the worker-firm match. Still, we observe significant heterogeneity in the share of firms adopting incentive pay schemes as well as in the type of schemes implemented. In this report we produce, for the first time, a wide array of empirical results to document such heterogeneity, both between and within countries.

In this study, we find that the diffusion of incentive pay schemes ranges from around 10-15 percent in some European countries to over 40 percent in Scandinavian countries and the US. When we investigate the relative importance of the different type of schemes, we find that individual pay and profit/gain sharing schemes are widely diffused, while share ownership schemes are much less common (particularly in Europe). We also document a number of empirical regularities. Incentive pay is found to be less common in countries where there is a large majority of small firms or where the share of family firm is larger. Higher product and labour market regulation is associated to a lower diffusion of incentive pay. Capital market development is a necessary requirement for a wider diffusion of incentive pay (i.e. in particular sharing and ownership schemes). When we control for a large set of individual characteristics and company attributes, we find that the probability that a worker is covered by an incentive scheme is higher in large sized firms and in high-skilled occupations, while it is much lower for females. Incentive schemes are also much less diffused in the public sector.

In order to assess the effects of the introduction of performance related schemes on a number of economic outcomes, we present three 'case studies' in personnel economics which use company-specific data. Each study pays particular attention to the internal features that govern the organisation of work, as well as the institutional environment in which firms operate.

In the first case study, we look at the effects of changing the measure of performance from sales to profits in a chain of cafes and restaurants in which the store managers receive incentive pay while regular employees only receive a fixed wage. We find that, by linking the pay of the local manager to store profits forces them to internalise production costs (namely, labour costs) thus increasing productivity (by about 1-1.5%) and enabling managers to respond more efficiently to changes in the demand by adjusting all production inputs.

The second case study uses data for all firms in the metal engineering industry in Italy to explore the effects of a nation-wide collective agreement that facilitated the introduction of incentive pay. We find that the agreement did increase the rate of adoption of incentive pay schemes and that, in turn, this resulted in an increase in productivity by about 5-6%.

Our last case study looks at the effects of two particular forms of incentive pay, namely profit sharing and employee share ownership, on firm performance and a self-reported measure of work pressure. Results show that excessive work pressure can be harmful for firm's performance.

In the final part of the report, we bring together the results of all our analyses and our critical reading of the existing literature, both theoretical and empirical, and we ask whether government should intervene to support the implementation of incentive pay schemes. In particular, in the light of the current economic recession we ask whether the introduction or a wider diffusion of incentive pay may be regarded as a way to consolidate and speed up the recovery.

The case for government intervention in this area is not obvious. While in general companies that use pay for performance do better (or no worse) than others, in terms of productivity and profits; the large heterogeneity observed, across firms and institutional contexts, suggests that not all firms in all circumstances are going to benefit from incentive pay.

To the extent that some firms eschew pay for performance and financial participation through lack of knowledge or adherence to the *status quo*, then moving them in a more productive direction can justify a policy to encourage greater incentive pay or financial participation. Policy intervention may range from training programs (about 'best practices' and how to implement them), to fiscal incentives or subsidies or, even, to mandating programs.

But it may be that governments are the wrong agency for instituting policies. Schemes that give tax breaks to firms with performance for pay schemes will primarily benefit the firms and workers that already have them, or may induce firms to change the form of pay to gain tax advantages without changing how they actually operate. Having seen the effects of the untested *laissez-faire* changes in the rules governing banks on the global economy, it makes little sense to undertake any reforms without detailed simulations of what they may do to the economy under alternative economic scenarios based on sound analysis and extensive discussion with labour, management, and government decision-makers.

Alternatively, trade unions and employers federations may find collective bargaining a more efficacious way to press for changes in compensation and ownership. Unions have agreed to greater decentralised productivity bargaining in Europe, negotiate over the profit sharing schemes in France and Italy, and have a mixed record of supporting and opposing employee ownership and profit-sharing in the US depending on economic conditions.

There are policies that could encourage the spread of group incentive pay and financial participation among firms that deserve consideration. For example, France has a mandatory profit sharing policy for medium sized and large firms. The US allows firms to "deduct compensation expenses" as a cost of business rather than as distributions of profit, only if the plans cover all workers in the firm proportionate to their wages or in some other fair way. Finally, another possible innovative way to encourage firms to experiment with more group pay for performance schemes and financial participation would be to offer prizes for firms that had the most successful innovations. Each year Fortune Magazine reports on the "best workplaces" in the US and there is a similar report on the best places to work in the UK (www.greatplacetowork.co.uk). In the US the best workplaces have better financial performance and are far more likely to pay workers through incentive pay and with financial participation than other firms. Prizes and contests can be fruitful ways to encourage innovation at low cost.

More generally, given what we know and do not know the best approach would seem to be to design experiments or pilot projects that might try several different ways to encourage the spread of group incentive pay and financial participation schemes that seem to offer productivity advantages over other forms of organising and paying labour.

Can relating workers pay more to the performance of firms help economies adjust in the current crisis? To the extent that part of the crisis was due to the excessive concentration of incentives at the top of firms in finance and elsewhere that generated huge risk-taking that spread toxic assets around the world, increasing normal employees share of performance-related and ownership might help prevent a restoration of the same incentives that contributed to the financial disaster. It is possible that policies that gave advantages to new firms in which workers had group incentives and financial participation might increase the rate of new firms forming, which would help in recovery. But while there is evidence that new firms in high-tech tend to use these modes of compensation, there is no evidence that policies to encourage the practice would in fact have the desired impact in job creation. Experimentation is the necessary path to a better understanding of how policies are likely to work in different institutional context and economic conditions.