fondazione RODOLFO DEBENEDETTI

# Paying for Performance

## Incentive Pay Schemes and Employees' Financial Participation

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# Motivation

- A growing proportion of firms are moving toward compensation systems which make part of pay depend on performance
- Incentive schemes are expected to:
  - motivate workers to be more efficient
  - increase attachment and identification with the interests of the firm
  - improve interpersonal relationships
  - raise job satisfaction
  - lower absenteeism and waste of intermediate material or capital
  - lower turnover rates
- … all of which should produce lasting effect on company performance
- Still, there is significant heterogeneity in the share of firms adopting incentive pay schemes as well as in the type of schemes implemented

# What do we do?

- Critical reading of the existing literature, both theoretical and empirical
- Documents a wide array of empirical results on the patterns of performance related pay both within and across countries
- Three ‘case studies’ in personnel economics, which use company-specific data, and provide new evidence on the economic effects of incentive schemes
- Should government intervene to support the implementation of incentive pay schemes?
  - 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

# Plan of the talk

- Introduction
- Forms of incentive pay
- Some empirical regularities
- The theory of incentive pay
- What do we know? Empirical evidence
- New evidence on performance pay
  - Three “case study” on the effects of PRP on firm’s performance
- What policies ?

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# Forms of incentive pay

- **Principle**: better performance is rewarded (as opposed to time spent at work)
- **Old idea**: sharecropping in agriculture, piece rates documented in the 1700s, employee ownership in the 1800s
- Two broad types:
  - performance pay (for individual or team)
  - financial participation where property rights shared with employees (profit sharing and employee share ownership)

# Performance Related Pay (PRP)

- **Individual**
  - Pay depends on individual employee's performance (i.e. piece rates, sales commissions, tips)
  - Performance measure is objective or subjective ("merit pay" based on performance appraisal) or a combination
  - Subjective measures especially vulnerable to prejudice/ discrimination, objective measures can be too narrow
- **Group**
  - Bonuses based on small-group performance
  - A number of measures used

    examples: project completion, output, rejects, time down for repairs, customer complaints

# Financial Participation

- **profit sharing** (i.e. share of profit)
  - based on firm-level performance (profit and/or productivity, quality indicators, etc.)
  - cash or deferred or even in company shares
  - bonuses may depend on pay, length of service, absenteeism, etc.
- **share ownership** (i.e. appreciation in share value)
  - Free or discounted shares offered to employees as part of incentive plan or in privatisation (one-off operation)
  - Affects income and employee's wealth as share price varies (losses possible)
  - Shares may be freely tradable or held in trust for employees (employees often but not always involved in governance / managing their shares)

# Institutional details

- **Government support**
  - **Aims**: redistribute wealth, employees involvement in firms
  - mostly come in form of **tax breaks** (especially on payroll and/or corporate tax)
    - **US:** ESOP scheme subsidises bank loan to buy shares for employees
    - **FR:** profit sharing compulsory in medium-sized and large firms, schemes have to be offered to all employees on the same terms
    - **UK:** schemes are regulated, same terms for all workers
- **Social partners**
  - Schemes often negotiated with labour unions (in France, Ireland, Italy)
  - firms may also introduce financial participation to keep unions out (also as defence against hostile takeovers)

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# Stylised facts

- *Are there significant differences in the diffusion of incentive schemes across and within countries?*
- Difficult to make strong comparative statements about country differences in incentive schemes

  $\Rightarrow$ data from official sources on the incidence and diffusion is relatively scarce

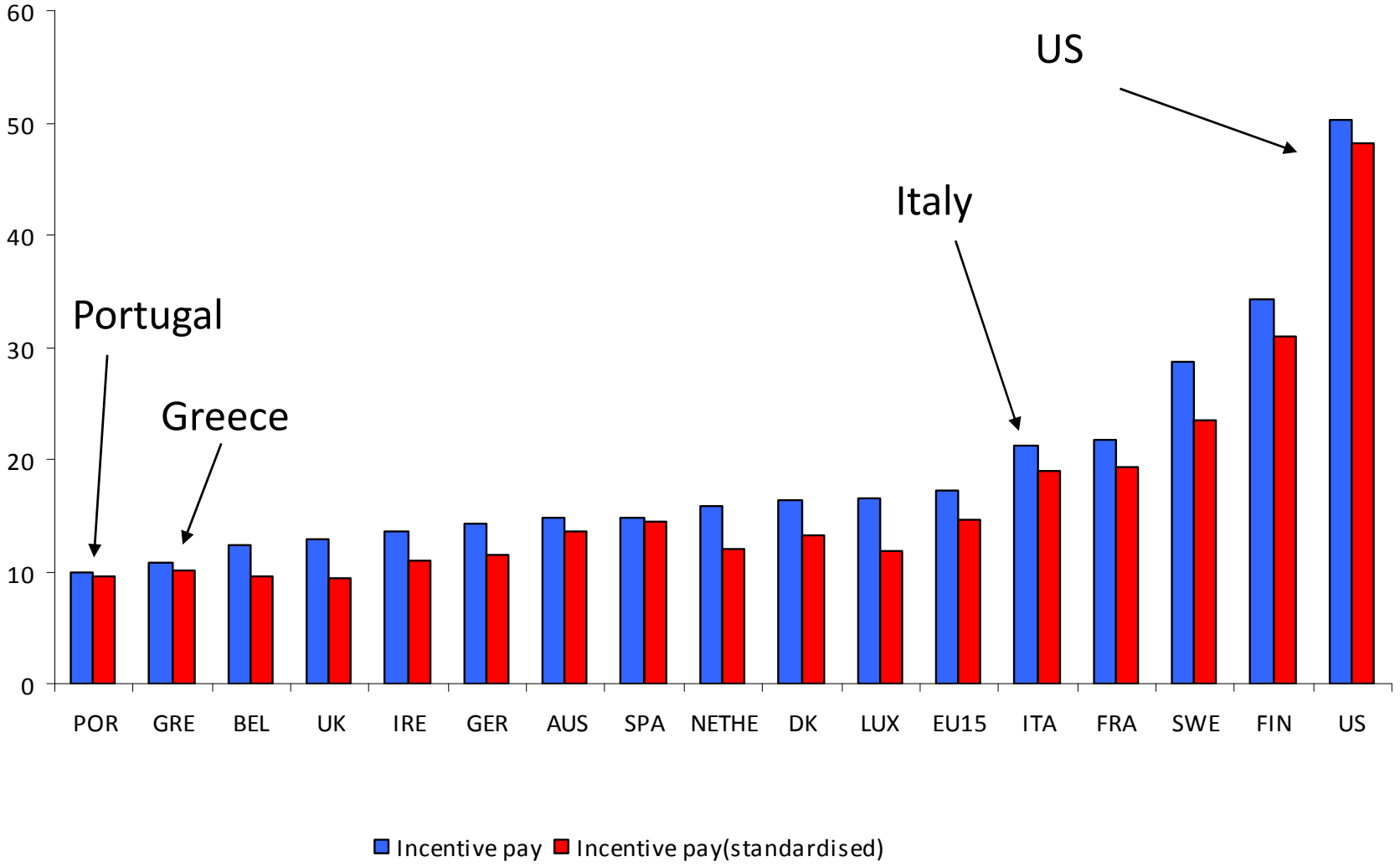
  - **US studies** report significant growth in the percentage of employees covered by incentive pay schemes in recent decades (but significant heterogeneity in statistics)
  - **EU studies** show that the overall incidence of incentive schemes, in the private sector, has been growing, still falls short of the levels in the US

# Data

- Evidence on incentive pay and financial participation in two surveys of individuals in households
  - **European Working Conditions Survey** (EWCS) - years 2000 and 2005
  - **General Social Survey** (GSS) – years 2002 and 2006 ("shared capitalism" module)
- **Sample selection**: employees with a permanent contract, employed in private sector and in profit oriented firms. Managers and CEOs are excluded

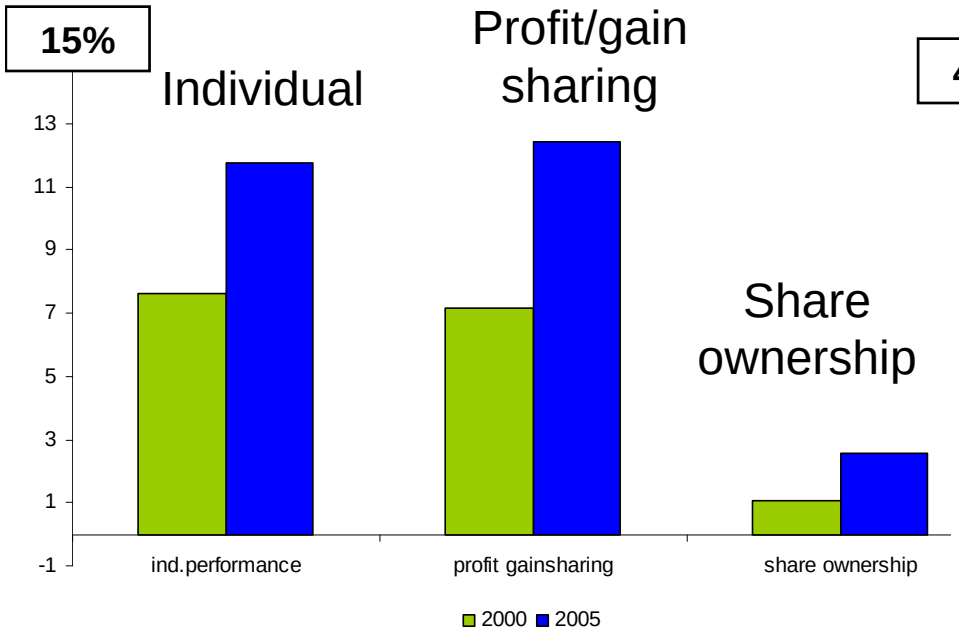
  (i.e covered in Part 1 - Conyon *et al*., 2010)

# Incidence of incentive pay across countries

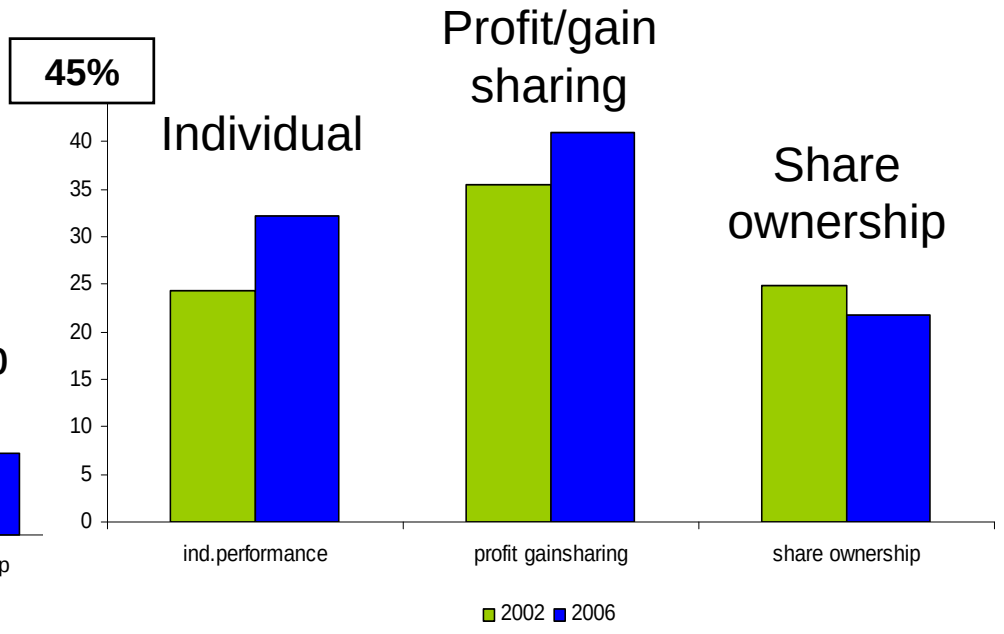


# Individual PRP and financial participation

a) Europe (2000-2005)§



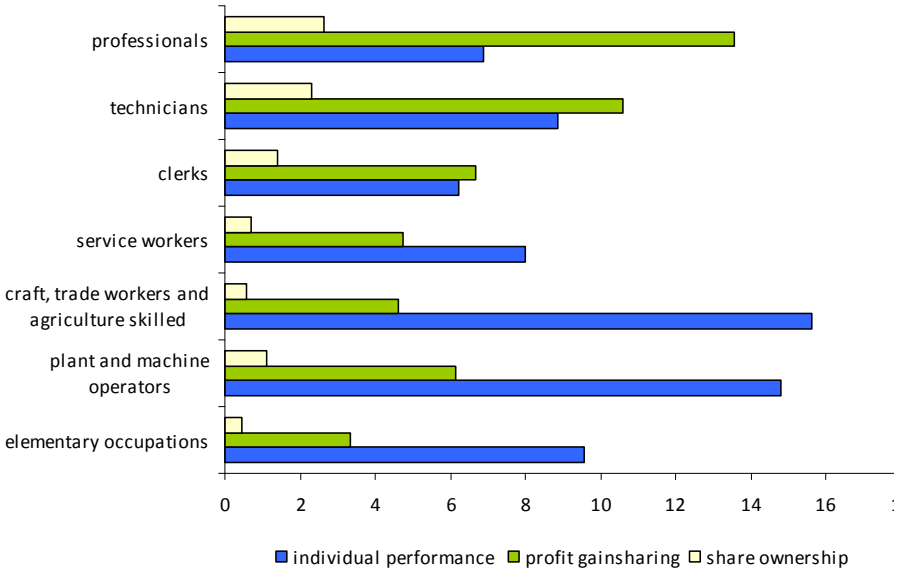

b) US (2002-2006)§



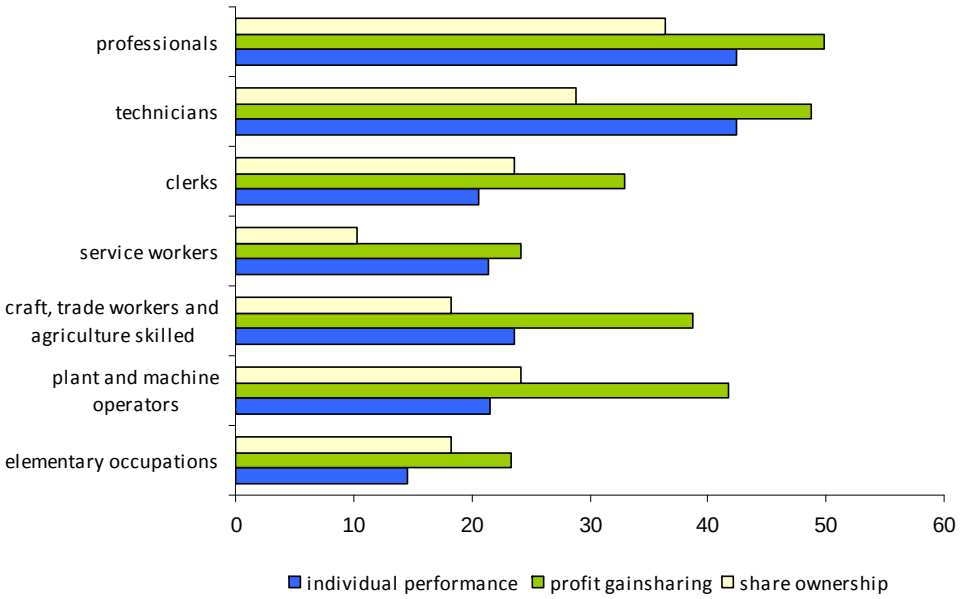

Source: EWCS (2000-2005) and GSS (2002-2006) data.
Note: figures are computed using sampling weights
§ Y-axis , EU and US have different scale

# Incentive schemes by occupation

a) Europe



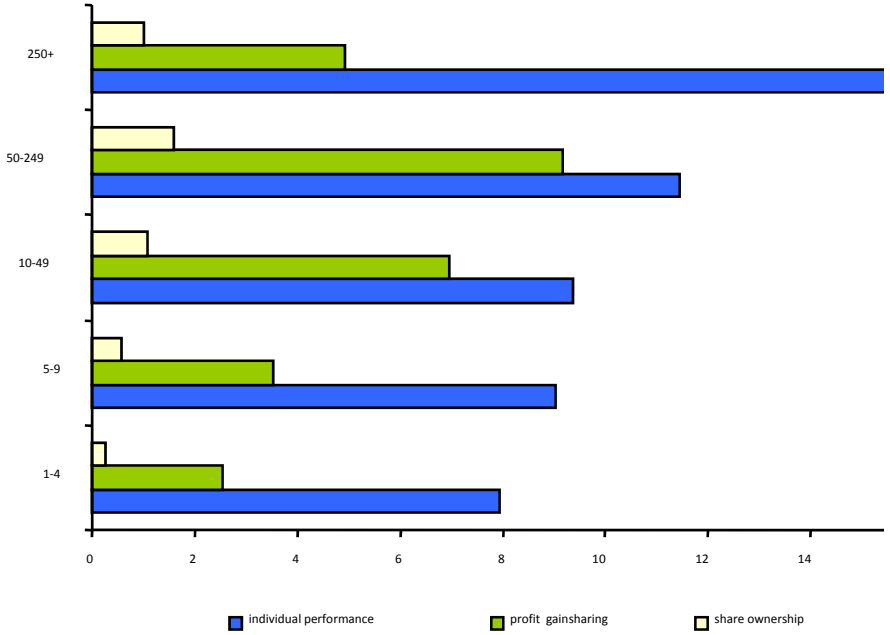

b) US



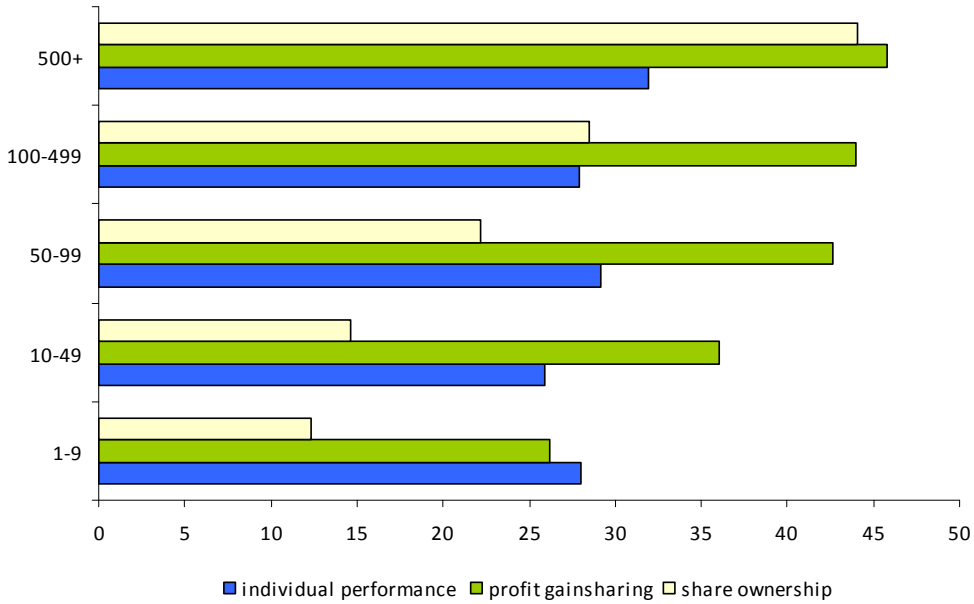

Source: EWCS (2000-2005) and GSS (2002-2006) data.
Note: figures are computed using sampling weights

# Incentive schemes by firm size

a) Europe




b) US




Source: EWCS (2000-2005) and GSS (2002-2006) data.
Note: figures are computed using sampling weights
§ EU and US have different firm-size classes

# Descriptive statistics

- Employees on incentive pay versus fixed pay are (*partial effects from probit*):
  - more likely to be males (+8% EU; +12% US)
  - more highly educated (+5% EU; 25% US)
  - work in large sized firms (EU+250: +13%; US +500: +25%)
- Incentive pay scheme are more likely where firms adopt “high involvement management” practices
- The proportion of workers covered by two (or more) schemes is higher in the US (25.2 percent) as compared to EU (1.4 percent)

# Decomposition (Blinder-Oaxaca )

## Decomposition over time (2000 versus 2005)

| | EU | | US | |
|---|---|---|---|---|
| | coef | % | coef | % |
| Characteristics | -0.002 | -3.63 | 0.0177 | 37.92 |
| Coefficients | 0.742 | 103.62 | 0.029 | 62.07 |
| Raw differential | 0.0716 | 100 | 0.0467 | 100 |

## Decomposition Europe versus US

| | US vs EU | |
|---|---|---|
| | coef | % |
| Characteristics | 0.0513 | 14.96 |
| Coefficients | 0.292 | 85.04 |
| Raw differential | 0.342 | 100 |

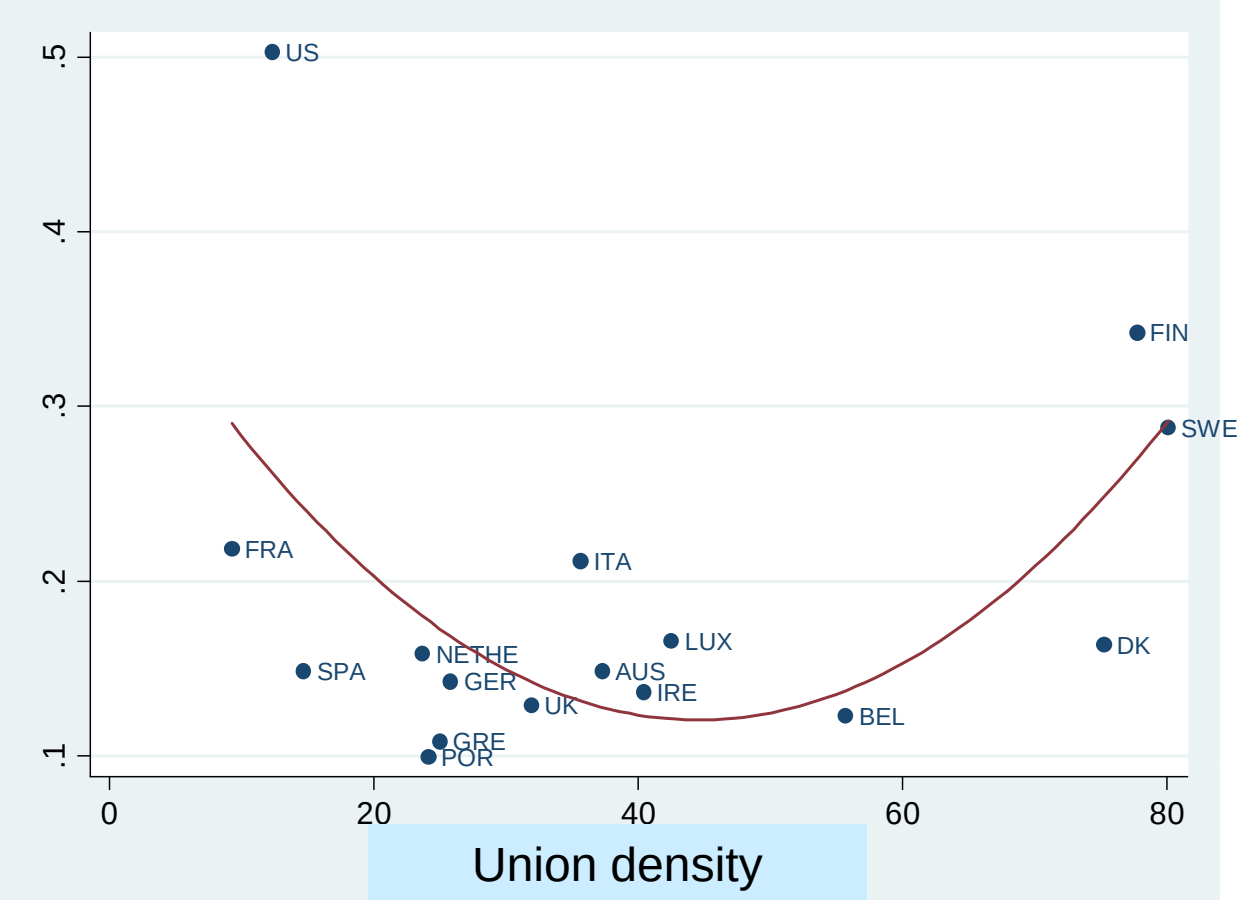
Note: Blinder–Oaxaca type decomposition for non linear estimation

# Empirical regularities

- We detected a number of empirical regularities between the diffusion of incentive pay schemes and selected country characteristics
  - Share of small firms
  - Unionisation and excess bargaining power
  - Product and Labour market regulation
  - Capital markets development
  - Output variability
  - Index “high involvement management practices”

# Empirical regularities/1

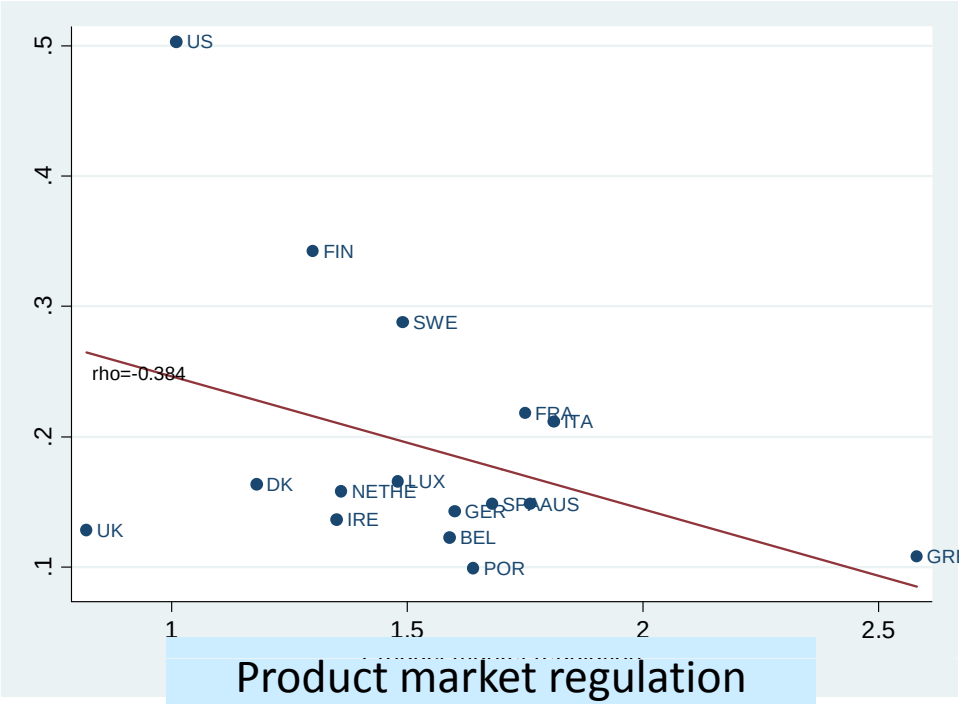
## Incentive pay and unionisation



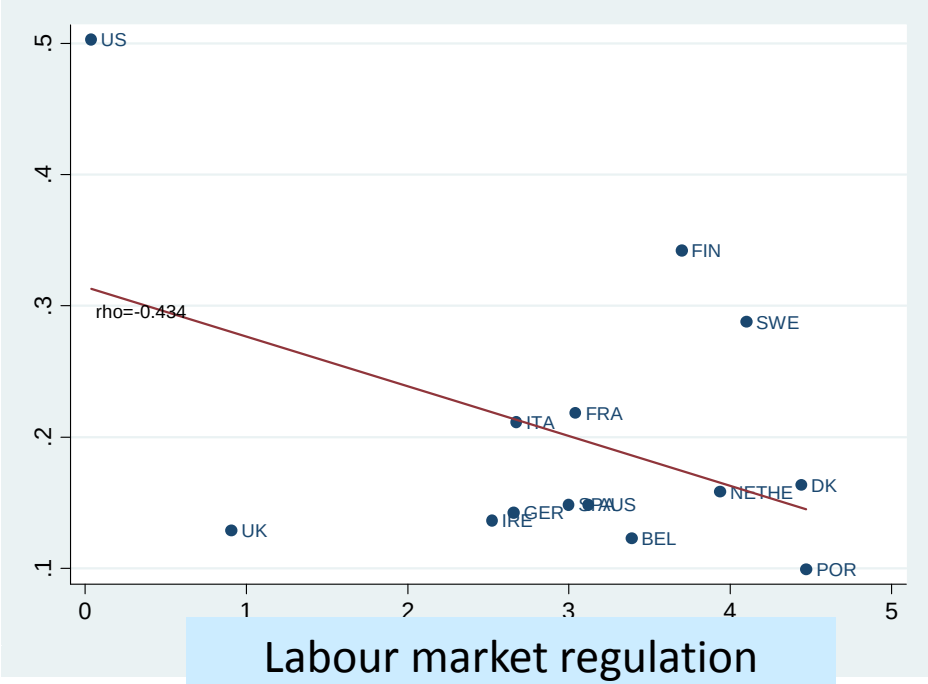

Source: EWCS, GSS and OECD institutional data.
Note: country averages (2000-2005 EWCS; 2002-2006 GSS)

# Empirical regularities/2

## Incentive pay and market regulation




Product market regulation

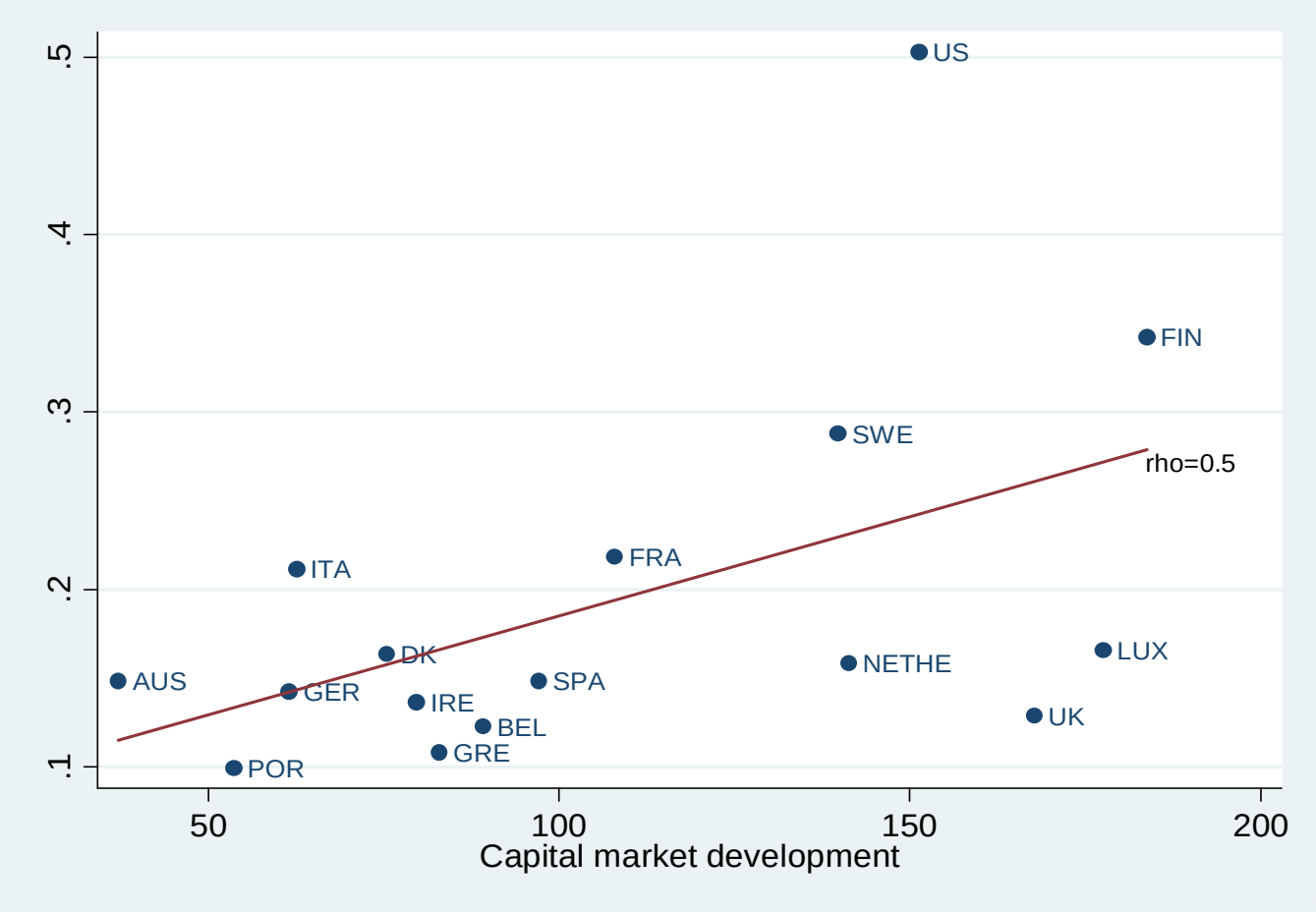



Labour market regulation

Source: EWCS, GSS and OECD institutional data.
Note: country averages (2000-2005 EWCS; 2002-2006 GSS)

# Empirical regularities/3

## Incentive pay and capital markets development




Source: EWCS, GSS and World Bank Capital market index.

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# The theory of incentive pay

- Why do firms adopt incentive pay and what are the effects?
- Imperfect information: “moral hazard”…
  - Employers do not observe employees’ effort, only output
  - Under fixed-wages employees exert less-than optimal effort
  - Performance related pay induces higher effort

# Extensions

- Extensions:
  - Workers are **heterogenous**: *High* and *Low* productivity $\Rightarrow$ "adverse selection"
  - Individual output is **not perfectly observable**:

    $\Rightarrow$ group output $\Rightarrow$ free riding $\Rightarrow$ monitoring
  - **Multitasking** $\Rightarrow$ aggregate performance, subjective evaluations (favoritism)
- What is (still) missing:
  - Unions: monitoring agency, adverse to wage dispersion
  - Adoption: experimentation, multiple schemes

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# Empirical Literature: What do we know?

- A number of empirical studies on the association of profit-sharing and employee ownership with productivity yield **modest positive relations** that may or may not reflect "causal" patterns
  - production function type analyses
- Some recent studies compare performance for the same firm or workers when they operate under **fixed wages** and under some **pay for performance scheme**

# Methodological Challenges

- Firms that adopt pay for performance may do so for reasons correlated with their actual performance:
  - Maybe firms adopt PRP schemes when they are doing well (badly)?
  - Maybe PRP simply indicates a "good management"
  - Often PRP introduced along with other changes (ie. new managers, work re-organisation, team work, etc.)?
- If we ignore these $\Rightarrow$ (upward) bias in estimation
  - Need to know the (unobserved) counterfactual outcome, that is, productivity/profits in the absence of performance pay …

# Empirical studies

- Different **strategies in empirical studies**:
  - Best evidence from "random assignment" (ie. experiments quite rare)
  - Exploit "natural" or "institutional" shifts in assignement: Before&After, Diff-In-Diff (with fixed effects), etc.
  - Dynamic panel modelling
- Still, how do we know whether positive effects for one firm/place/time will translate into positive effects for **new adopters**?
  - due to heterogeneity and interactions with country-level institutions
- External validation: extrapolating from results based on a subset of current adopters may be problematic for policy (ATT ≠ ATE)
  - single firm case studies ("insider econometrics")
  - specific sectors or occupations

# Individual performance pay

- Focus on cases where **output** easy to observe, **inputs** costly to monitor, workers can improve performance via own efforts (i.e. tree-planting, fruit pickers, jockeys, etc.)
- Substantial productivity gains in switching to piece-rates
  - Part due to **worker sorting**, part is **incentive effect** [Lazear, 2000]
- However, costs can outweigh productivity gains
  - costly monitoring under piece-rates can make time-rate pay more profitable [Freeman and Kleiner, 2005]
- <u>Further problems</u>:
  - Endogeneity: unobserved factors affect both the choice of pay system and productivity (some exceptions, [Shearer, 2004])
  - Piece-rates: no evidence on "merit pay" yet it is more prevalent
  - lack of information: proportion of pay linked to performance

# Group incentive pay

- Focus on cases where there is a switch from piece-rates to group incentive pay
  - Positive productivity effects despite "free riding" (i.e. 1/N problem)
  - Show importance of worker co-monitoring
  - Effects often consistent with social interactions of the kind predicted by behavioural economists (i.e. social connections, norms and peer effects) [Bandiera et al. 2009]
- Further problems:

  -Endogeneity: Usually examine switch from piece to group pay but difficulties isolating pay change from other changes, i.e. introduction of team working

# Financial participation

- Focus on cases where there is a switch from time-rate pay to profit sharing and/or share ownership
  - Often **small positive effects** but evidence of upward bias (adoption when firm "do well") or downward bias (adoption when firm "do badly")
  - Combinations of financial participation with **other incentive pay schemes** often key to success (i.e. explain firm switching across pay regimes)
  - Importance of interactions with **HR practices** and other governance practices
  - Importance of institutional features: ***Japan*** "strong effect" [Jones et al. 1995; Kato et al. 2002] versus ***Finland*** "no effect" [Jones et al. 2010]

- <u>Further problems</u>:

  -Endogeneity: difficulties in plausibly identifying causal effects, standard approach is dynamic panel modelling (no randomisation, more confounding factors, etc.)

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# Case study 1: "Incentive effects of PRP in a catering services company"

- Chain of stores in Italy
  - Store managers are paid for performance
  - Other employees are on fixed wages
  - Store managers have (partial) control of employees working hours
  - Measure of performance changed from sales to profits
- Very common set-up but rarely studied
  - Chains of shops, restaurants, retail banks, some public sector services

# Key insights

- When performance is measured with **sales** there is an incentive to use excess labour – i.e. the cost of production inputs is not internalised
  - Hence, excess working hours and lower productivity

- When **profits** replace sales (as a measure of the manager's performance) we expect sales to decrease and labour productivity to rise
  - the manager will seek to reduce the cost of salaried workers
  - less room to adjust to demand shock

# Data

- Quarterly data for 186 stores (bars and restaurants) from 2000:Q1 to 2006:Q4
- Available info: sales, worked hours, profits, wages, manager ID and demographics
- Stores provide services to travellers on main European roads (additional data on: traffic flows)

# Identification

- All store change performance measurement at the same time

  - time effects are collinear to the effect of the new system

- Alternative identification strategies:

  - Assume specific functional form for the time effects (quadratic polynomial)

  - Look at interaction with traffic flows (arguably exogenous)

# Results (1)

| | Log worked hours (1) | Log sales (2) | Log productivity[1] (3) | Log profits[2] (4) |
|---|---|---|---|---|
| **Panel A** | | | | |
| 1=after 2003q1 | -0.037*** | -0.022** | 0.016*** | -0.084*** |
| | (0.007) | (0.009) | (0.004) | (0.014) |
| Manager characteristics | no | no | no | no |
| Manager fixed effects | no | no | no | no |
| **Panel B** | | | | |
| 1=after 2003q1 | -0.037*** | -0.022** | 0.016*** | -0.080*** |
| | (0.007) | (0.009) | (0.005) | (0.014) |
| Manager characteristics | yes | yes | yes | yes |
| Manager fixed effects | no | no | no | no |
| **Panel C** | | | | |
| 1=after 2003q1 | -0.035*** | -0.022** | 0.013** | -0.086*** |
| | (0.007) | (0.009) | (0.006) | (0.017) |
| Manager characteristics | yes | yes | yes | yes |
| Manager fixed effects | yes | yes | yes | yes |
| Observations | 4,258 | 4,259 | 4,259 | 2,831 |
| Number of stores | 186 | 186 | 186 | 186 |
| Number of managers | 348 | 348 | 348 | 296 |

# Results (2)

| | Log worked hours (1) | Log sales (2) | Log productivity (3) | Log profits (4) |
|---|---|---|---|---|
| **Panel A** | | | | |
| Log of Traffic | 0.026*** | 0.045*** | 0.019*** | 0.069*** |
| | (0.007) | (0.010) | (0.005) | (0.016) |
| [1=after 2003q1] x log Traffic | 0.011* | 0.019** | 0.008 | 0.009 |
| | (0.006) | (0.009) | (0.005) | (0.013) |
| Manager characteristics | no | no | no | no |
| Manager fixed effects | no | no | no | no |
| **Panel B** | | | | |
| Log of Traffic | 0.024*** | 0.042*** | 0.018*** | 0.071*** |
| | (0.008) | (0.010) | (0.005) | (0.016) |
| [1=after 2003q1] x log Traffic | 0.012** | 0.020** | 0.008 | 0.006 |
| | (0.006) | (0.009) | (0.005) | (0.013) |
| Manager characteristics | yes | yes | yes | yes |
| Manager fixed effects | no | no | no | no |
| **Panel C** | | | | |
| Log of Traffic | 0.029*** | 0.048*** | 0.019*** | 0.063*** |
| | (0.008) | (0.011) | (0.005) | (0.017) |
| [1=after 2003q1] x log Traffic | 0.009 | 0.014 | 0.005 | 0.015 |
| | (0.007) | (0.011) | (0.006) | (0.015) |
| Manager characteristics | yes | yes | yes | yes |
| Manager fixed effects | yes | yes | yes | yes |
| Observations | 3,480 | 3,481 | 3,481 | 2,316 |
| Number of stores | 151 | 151 | 151 | 151 |
| Number of managers | 300 | 300 | 300 | 256 |

# Case study 2: "Decentralised bargaining and firm performance"

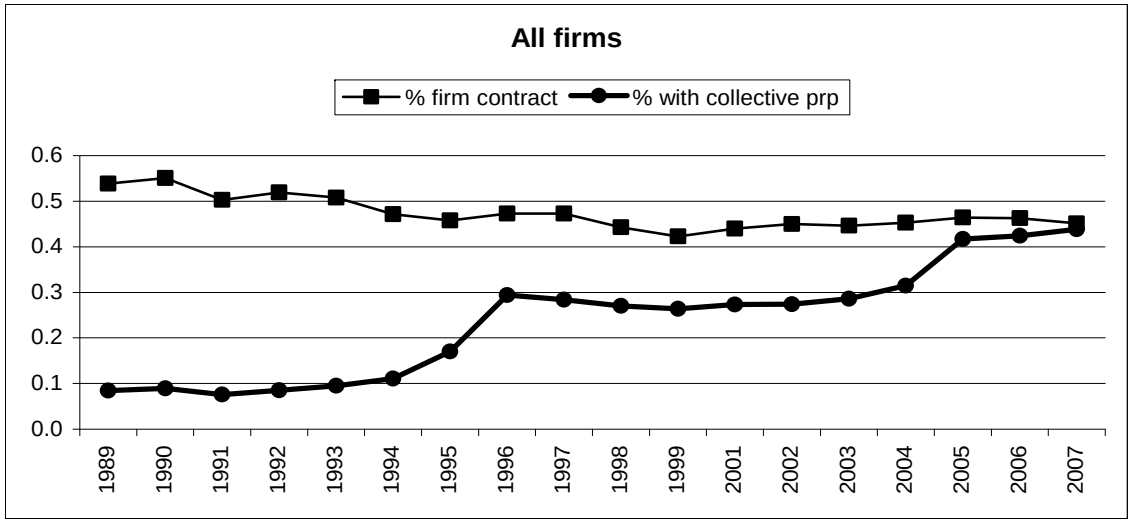
- In Italy (1993), was introduced a two-stage bargaining system: (1st) National-level, (2nd) Firm-level
  - **National level**: maintain purchasing power of wages
  - **Firm level**: collective performance related pay schemes linking wage increases to firm's performance indicators (productivity, profitability or other) to be determined by the employers and local unions
  - Tax breaks (weak and not until 1997)

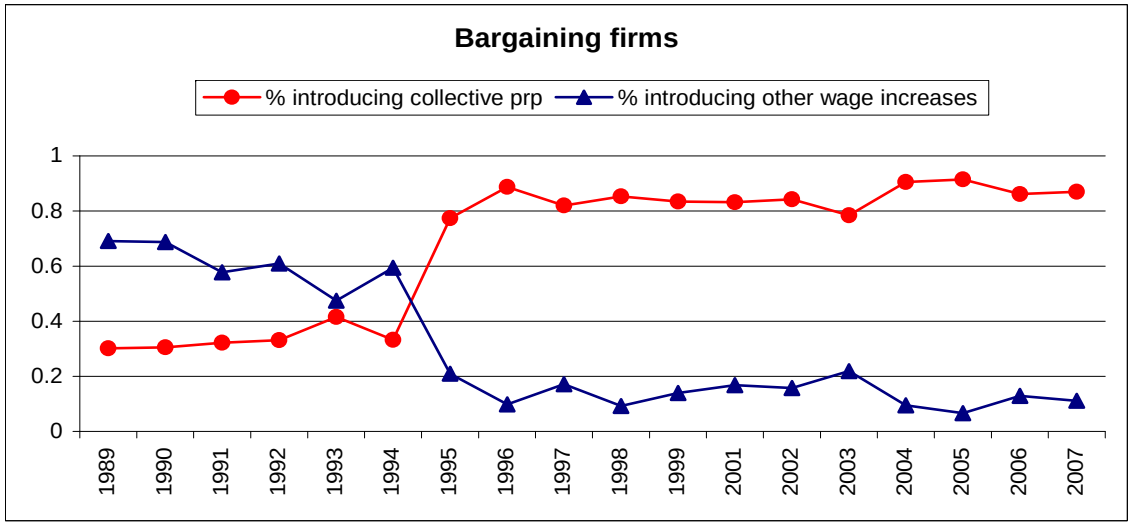
# Data and empirical strategy

- Sample of Italian metal engineering firms (Federmeccanica)
  - Approximately 3,000 establishments per year (425,000 employees) covering (10% of firms and 25% of workers)
  - waves from 1989 to 2007 (info on productivity up to 2001)
  - Collectively bargained pay increase: “premio di risultato”
  - Firms in South Italy under-represented
- 10% of firms and 40% of total workers (20% and 55% in metal engineering) introduced firm level bargaining and some performance-related pay scheme

# Incidence of collective PRP

Incidence of firm-level contract and collective PRP, 1989-2007



# Empirical strategy

- **Treatment evaluation problem**, where the "treatment" ($T$) is the introduction of collective PRP
  - $Y_{it}$ is the outcome (performance in firm $i$ at time $t$ )
  - $T$ is equal to 1 when collective PRP is in place
  - vector of time-variant control variables
  - $\vartheta_i$ firm specific fixed effect
- to account for the (potential) endogeneity of treatment we use the 1993 Agreement as "natural experiment"

# Descriptive statistics

- firms introducing collective PRP schemes are quite different from the other firms in terms of :
  - Size, workforce composition, working time, industrial relations
- Also firms with collective PRP are more productive, pay higher wages, have lower turnover rates, less absenteeism and more within wage inequality (differences are statistically significant)
- Oaxaca decomposition: 88% of productivity differential (with and without collective PRP) due to different observable characteristics

# Effect of PRP on productivity

**Table 6.2.2 Effect of PRP on labour productivity, 1989-99**
**Linear FE estimates; dep var: log of real sales per worker**

| | All | | | | | | Only firms with contract | Treated firms introducing prp since 1995 |
|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| PRP | 0.064*** | 0.065*** | 0.066*** | 0.059*** | 0.059*** | 0.052*** | 0.046*** | 0.050*** |
| | (0.01) | (0.01) | (0.01) | (0.01) | (0.01) | (0.01) | (0.01) | (0.01) |
| time fixed effects | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| firm size | No | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| workforce characteristics | No | No | Yes | Yes | Yes | Yes | Yes | Yes |
| working time schedules | No | No | No | Yes | Yes | Yes | Yes | Yes |
| other firm characteristics | No | No | No | No | Yes | Yes | Yes | Yes |
| industrial relations | No | No | No | No | No | Yes | Yes | Yes |
| R2 (overall) | 0.234 | 0.226 | 0.266 | 0.284 | 0.296 | 0.297 | 0.325 | 0,303 |
| N obs | 29153 | 29153 | 27618 | 27618 | 27618 | 27618 | 14128 | 26206 |
| N firms | 8604 | 8604 | 8212 | 8212 | 8212 | 8212 | 4326 | 8066 |

Note: Robust standard errors in brackets. *** Statistically significant at 1%

# Other effects

- **Type of scheme**: productivity effects are smaller in firms whose collective PRP scheme is relatively complex or linked to profitability indicators
- **Employment**: overall effect of collective PRP on employment is usually positive but small (less than 1%);
  - higher employment stability (retention of white collar workers) particularly during adverse business cycles
- **Wage inequality**: introduction of PRP increases wage inequality (by around 3%)
  - Regardless of the inequality measure used

# Case study 3: "Profit Sharing, Work Pressure and Productivity"

- Since the late 1950s France has had regulated profit-sharing schemes (mandatory for medium-large firms)
- Consider the possibility that incentive pay may be associated with increased work pressure and adverse effect on productivity
  - employees over-exert themselves with detrimental effects on (their) health and (firm) long-run performance
  - also ambiguous welfare implications, as employees may accept more pressure at a given pay level than would be optimal for themselves

# Data and Empirical Strategy

- 'REPONSE' - employer-employee survey
  - info on incentive schemes, employee motivation, etc. for a sample of employees in each firm
  - representative sample of 910 firms in industry and services, observed in 1998 and 2004
- Hypotheses:
  - profit sharing increases work pressure
  - Both work pressure and profit sharing affect performance
- Measures
  - work pressure: binary (value 1 if employees say they "always" have to rush in their work, 0 otherwise)
  - firm performance: **(a) Binary** (1 if profitability "much better" or "better" than competitors', 0 otherwise); **(b) value added, fixed assets, employment** (note: only for 338 manufacturing firms)

# Estimation

- **Work pressure equation (individual level)**
  - demographics, incentive schemes, employee involvement, hours worked, etc; firm attributes, size, market strategy, etc.)
    - Profit sharing instrumented (i.e. lagged firm-level attributes)
- **Performance equation (firm level)**
  - a) **Performance indicator (1,0)**: firm-level attributes, average work pressure, profit sharing
    - Work pressure and Profit sharing instrumented
  - b) **Performance indicator (log of output)**: employment, fixed assets, firm-level attributes, average work pressure, profit sharing (note: only Manufacturing firms)
    - Work pressure and Profit sharing instrumented

# Results

- **Profit sharing**
  - profit-sharing plan decreases work pressure reported by employees; other incentive schemes may increase work pressure when they are targeted at management (less robust)
- **Performance equation (firm level)**
  - a) **Performance indicator (1,0)**: both profit sharing and work pressure increase performance
  - b) **Performance indicator (log of output)**: profit sharing increases performance in Manufacturing firms, while work pressure (now) decreases productivity
  - Employee share ownership has a neutral effect

# Plan of the talk

- Introduction
- Forms of incentive pay
- Some empirical regularities
- The theory of incentive pay
- What do we know? Empirical evidence
- New evidence on performance pay
  - Three “case study” on the effects of PRP on firm’s performance
- What policies ?

# What policies ?

- Should governments seek to encourage further development of pay for performance and employee financial participation in their firms?
- If so, what  policies might they choose?
  - We try to answer balancing the scope for intervention "today" (with a wide band of confidence), with the need of collecting further evidence to make a "more informed" recommendation (and with greater confidence)
  - We also contrast the case for policies to **encourage greater adoption** of pay for performance and the case for **doing nothing**.

# Are policy interventions justifiable?/1

- **The case for new policies**
  - Heterogeneity in firms and workers, suggest that what is right for some firms and workers, it may be wrong for others
    - If firms stick to the *status quo* moving them in a more productive direction can justify a policy to encourage greater incentive pay (i.e. programs to educate firms about best practice, use tax breaks or subsidies or, even, mandating programs)
  - Maybe governments are the wrong agency for instituting policies
    - Trade unions and employers federations may find collective bargaining a more efficacious way to press for changes in compensation and ownership
  - Perhaps neither governments nor private groups can find a policy that in fact works $\Rightarrow$ "experimentation" is needed

# Are policy interventions justifiable?/2

- **The case against policy interventions**
  - 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
  - Also beneficiaries tend to be the "good" firms, which makes subsidies regressive
  - In the light of the effects of the untested *laissez-faire* in the rules governing banks on the global economy, it makes little sense to undertake any reform without detailed simulations of what they may do to the economy under alternative economic scenarios

# Possible policy interventions/1

1. **Mandatory schemes**
   - provide explicit formula to compute workers' share of profits (i.e. easier for small firms), but there are cost of imposing the same formula on firms that may face different economic conditions
2. **Fiscal incentives/1**
   - allow 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

# Possible policy interventions/2

## 3. Fiscal incentives/2

- give "tax breaks" to firms that introduce incentive schemes:
  - If many firms have profit-sharing "bribing" them with tax breaks will enrich them without any economic benefits
  - If tax breaks only to "marginal firms" penalises early adopters and creates the potential for firms to alter their ownership structure to gain the tax benefit

## 4. Best practices

- gather information about what works and what does not, publicise "best practices" through government agencies
- prizes and awards for "best workplaces"
  - *Fortune Magazine* reports on the "best workplaces" in the US
  - www.greatplacetowork.com, by the Greatplacetowork Institute

# Thank you