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The team that works together earns together

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The Team that Works Together Earns Together

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Group incentive programs boost productivity, promote innovation, and inspire teamwork.

One major objective of compensation programs is to motivate employees to perform if not excel at their jobs. Numerous programs for linking an employee's pay with his or her job performance have been tried since Taylor introduced his now famous piecework incentive system. The assumption that some or all of an employee's pay should be tied to individual performance as a means of obtaining the desired work behaviors is a well accepted concept in compensation today.

Lawler, Locke, and others have provided substantial documentation that, in situations where pay is related to individual performance, employee motivation is increased and the tendency for turnover is centered among poor performers. In fact, based on a rigorous examination of the empirical literature, Locke concluded that financial incentive programs were more effective motivators than were goal setting, job enrichment, and participation programs. Lawler has not only shown that pay is highly valued by employees, but also that employees prefer performance-based compensation systems to general increase programs.

A Popular Method

In recent years, merit pay programs have become the predominant method for motivating and rewarding job performance. A 1976 Conference Board report indicated that 88% of the companies surveyed had a merit pay program for at least some of their employees. Typically, merit pay is an incentive program where an employee's salary is reviewed and adjusted based on individual job performance. Where pay ranges are established, movement from the minimum to the maximum of the ranges is based on performance as opposed to seniority. Usually, an annual organization-wide merit budget is developed and divided among the various departments. Individual managers then distribute the monies based on an

assessment of the subordinate's performance. Performance is traditionally evaluated on the basis of employee traits, employee behaviors, or employee attainment of preestablished goals (Management by Objectives).

However, for reasons articulated by Meyer and Hills, many managers have become disenchanted with paying for performance. These criticisms have been directed toward the technical feasibility of rewarding individual performance as well as toward the undesirable consequences that may result from the installation of incentive programs. Unfortunately, when problems with paying for performance are discussed, the arguments are often reduced to the pros and cons of traditional merit pay programs, as typified by Lawler and Meyer's exchange of letters in *Organizational Dynamics*. However, there are other alternatives, and as a result, one does not have to accept or reject the pay-for-performance concept based on the strengths or weaknesses of the individual merit pay approach.

We believe that group incentive programs (GIP) represent not only a viable alternative for linking pay to performance but also may be superior to individual merit pay programs (MPP) in many situations. In this article, we briefly define and describe GIPs, then compare the GIP to the MPP in the context of specific organizational conditions. Finally, we examine the issues that must be considered for determining which incentive system (if any) will produce the best results.

Group Incentive Programs

In this context, a group incentive plan (GIP) refers to a pay-for-performance system that measures and rewards the performance and productivity of employees in work units. Group incentive plans range in scope from a small group of employees working against performance standards developed for their unit, to all employees of an organization receiving some financial reward based on company performance. However, group incentive plans generally may be described in terms of three major categories.

First, there are small groups or work unit incentive plans. In this category, performance standards, similar to those used under individual incentive plans, are established and rewards are allocated on group performance — not individual performance — against the standard. For example, a logging crew is rewarded for the amount of board feet of lumber produced, rather than each individual being rewarded for performing his or her task in the logging operation regardless of how much he or she produces.

The second major type of group incentive plan is the productivity improvement program. Under such a program, the primary goal is to improve organizational efficiency by encouraging innovative ideas and teamwork. Typically, employees from all levels of the organization participate in a process that develops and processes recommendations for improving organizational efficiency. Financial rewards are based on cost reductions, usually in the area of direct labor.

The Scanlon Plan is an example of a productivity improvement program. Committees are formed to elicit and evaluate employee suggestions for productivity improvements. Cost savings are determined by comparing the historical cost of labor to output (ratio) with the current labor cost to output. If the current cost is lower per unit produced, then the difference (dollars saved) becomes a bonus pool. The company's share and a reserve for future deficits (when current labor costs per unit are higher than the historical level) are deducted and the rest is divided among employees. The Rucker Plan, Kaiser-Steel program, and Improshare are also examples of productivity improvement programs.

The other major type of group incentive program is profit sharing. The employer rewards employees at some predetermined rate based on the profitability of the enterprise. These payments may be made directly to employees at regular intervals or withheld until the employment relationship is terminated, usually at retirement. Typically, only top-level executives participate in profit-sharing programs because they are believed to have the major influence on profits.

Conditions of Success

Most managers recognize that certain conditions must be present for rewards to elicit desired performance. Lawler has

provided a succinct list of these conditions, which can be used to compare the advantages and disadvantages of individual merit pay programs (MPP) and group incentive plans (GIP):

1) Important rewards can be given and tied to performance.

2) Information can be made public about how rewards are given.

3) Superiors are willing to explain and support the reward system in discussions with their subordinates.

4) Rewards can vary widely, depending on the individual's current performance.

5) Performance can be objectively and inclusively measured.

6) Meaningful performance appraisal sessions can take place.

7) High levels of trust exist or can be developed between superiors and subordinates.

It is often argued that a MPP may not provide a reward important enough to motivate performance. Because of competing needs for resources within the organization and competing pay objectives (for example, cost of living allowances, longevity increases, and across-the-board increases), the total money invested by organizations in merit increase programs is often insufficient to motivate employees. In addition, the number of people who must share this budget increases in relationship to management's ability to attract or develop qualified and motivated employees.

Theoretically, a GIP should have the same constraints placed on the total budget for incentive pay as do merit programs. However, a GIP is often more closely associated with the productivity and profits of the operation. As a result, this budget is designed to be flexible, based on organizational productivity rather than being a fixed amount that must be divided among high performers, as is common in a MPP. For instance, the Scanlon Plan provides a bonus pool that is the difference between budgeted labor costs and actual labor costs. As a result, the financial rewards are paid only when employee suggestions reduce the total cost of labor. Because the reward program does not increase labor cost and, in fact, may reduce them, it is easier for management to justify increased incentive payments.

In addition, peer recognition represents an important reward that a GIP can stimulate more effectively than a MPP. As Roy noted, individual incentive systems can foster rate restriction among production employees. Because merit pay budgets are limited, employees realize that high performers are going to receive a larger share of this budget. This realization will create mixed feelings at best toward the high performers. However, under a GIP, high performers are going to contribute to rewards obtained by all co-workers, which will certainly increase the value of the high performers to the members of the work unit.

Further Comparisons

Under a MPP, the reality of pay ranges and the need to maintain internal equity must be recognized. The better an individual performs, the more quickly he or she will move to the top of the pay range, whereas under the typical merit increase program, further increases (except for structure adjustments) cannot be given without distorting the pay structure.

This problem does not exist under most GIPs because incentive pay is given outside of the formal pay structure. In other words, each time the incentive pay is earned, payment is made, but the base salaries of employees remain unchanged. To further distinguish between incentive pay and base pay, many GIPs require that separate checks be issued to employees for their incentive payments.

High rates of inflation often have a negative impact on MPPs. Given realistic constraints on the organization's ability to provide pay increases, there is considerable employee pressure to preserve "real wages" by granting "merit money" to all employees regardless of actual performance.

Another related problem is the temptation that managers have to manipulate the MPP because merit pay is often the only portion of total pay that they control. For instance, the manager may give a large merit increase to an average systems analyst because tight labor market conditions make the systems analyst difficult, if not impossible, to replace.

GIPs are more difficult to manipulate than are most MPPs, where supervisor ratings are often subjective and may not

be subject to meaningful scrutiny. Typically, GIP performance standards are explicitly developed before the program is implemented and represent specific measures of output of the department or organization. Although inflationary and labor market pressures will still exist, these pressures will be directed toward having the compensation department adjust the pay system, rather than toward supervisors who may react to these pressures on a case-by-case basis.

Performance and Productivity

The ability to assess performance and productivity accurately is essential for any type of pay-for-performance program. The validity of performance appraisal programs (rating scales, checklists, essays, person-to-person systems, MBO, and combinations of the above) is being placed under increased scrutiny, as is evident by the court cases where discrimination concerning performance evaluation is alleged.

The assessment of performance for a MPP is often made by a supervisor who receives little training and is subject to intentional and unintentional bias. In fact, it is often not in the supervisor's best interest to provide an accurate assessment of the subordinate's performance. On one hand, low rating can induce a hostile reaction from the subordinate and may invoke questions concerning the supervisor's ability to select or manage employees. On the other hand, a high rating may increase the subordinate's demands for pay increases and "advancement opportunities" within or outside the organization. In either case, the supervisor increases the possibility that he or she will lose a valuable subordinate. Thus, it is no surprise that performance appraisal programs suffer from the tendency to rate everyone the same. Although approaches are available to counter these problems, the costs of program implementation and maintenance are heavy.

As most managers are aware, for many jobs it is extremely difficult to develop defensible measures (quantity, quality, timeliness, and cost) of individual job performance. However, measure of output for group efforts may be more explicit. For instance, an operating unit usually has such performance measures of profitability, return on investment, labor costs, waste, quality, etc., that are already available because these measures are needed to manage the operation.

Finally, from a performance measurement point of view, group incentive programs provide an administratively less cumbersome approach. Rather than developing measures for each position and appraising each individual's performance, only work units need be evaluated. Thus, a GIP can usually appraise results more frequently (often monthly) than the annual appraisal that is common for MPPs. Performance feedback can be done more frequently without substantially increasing the cost of the incentive program. The major disadvantage of this approach is that, with increased unit size, the individual's perception of his or her impact on unit performance may decrease.

Even if these technical problems of utilizing a MPP can be overcome, the desirability of using MPP to link pay-to-performance can also be questioned. As Deci points out, merit pay may have negative effects on self-esteem. Giving large increases to a few individuals is going to communicate to the majority of employees that they are, at best, average. The effect on morale and actual job performance has not been tested, but psychologists say expectations have a major impact on behavior.

Increased competition can also be a double-edged sword. Competition among employees for limited rewards may motivate people to perform at higher levels, but this competition may also lead to hostilities, distortion of communications, negative perceptions of others, and decreased interaction. Furthermore, it becomes irrational for employees to help each other, for by doing so, they jeopardize their own chances of receiving a large merit increase. Finally, one must ask if merit pay, which directs rewards to selected individuals, represents a sound method of enhancing productivity in large groups.

However, GIPs are designed such that cooperative behavior is encouraged. Employees can feel good about the total group efforts rather than comparing themselves with each other. Because performance reflects on the entire group, it is in the best interest of groups to help

poor performers to improve. Finally, a GIP communicates to employees that performance is determined by the interdependent efforts of the work group.

A Feasibility Analysis

Although merit pay programs can be excellent motivators of job performance under certain conditions, group incentive programs represent a viable alternative of rewarding performance for organizations that are unwilling or unable to reward performance on an individual basis. However, organizational objectives, organizational structure, and the work itself must be examined before determining the appropriateness of a MPP or any variation of a GIP. The following major issues should be considered in making this decision:

Size of the incentive unit. The incentive unit can vary from the single employee under an individual merit pay plan to every member of the organization that participates in a profit-sharing plan. Unit size represents trade-offs between the costs of developing, collecting, and reviewing performance data for the smallest unit (each employee) as opposed to a few large units, and the tendency of employees to believe that the larger the unit the less influence they have on performance and productivity. The organizational structure must also be considered because it influences the perception of work unit (team) autonomy and determines whether the efforts of the group affect performance and productivity.

Time span between performance feedback and rewards. Psychologists have found, in most cases, that the shorter the time span between effort and reward, the better. However, providing more immediate feedback must be weighed against the administrative costs, the size of the reward (more frequent rewards are necessarily smaller), and the natural work cycle that provides the performance indicators.

Selection of performance measures. Several criteria must be considered when selecting performance and productivity measures: 1) the cost of generating the data; 2) the meaningfulness of the measures to employees in the incentive unit; and 3) the impact that the performance indicators will have on organization operations (you get what you measure). It has been our experience that these measures should be constructed from currently used measures and be relatively easy to understand. As employees develop an understanding of productivity, more complex formulas can be developed to better reflect the relationship between employee contributions and outputs.

Reward amount and distribution. The reward certainly has to be significant enough to motivate increased performance. On the other hand, increased performance and production has to justify the extra cost (including both the incentive pay and program administration costs). One of the problems with merit pay is the difficulty in determining the value to the firm of increased performance. However, the value of the program is easier to evaluate under a GIP, as can be illustrated with the Scanlon Plan. The rewards distributed to employees are generated by actually reducing labor costs. Each month employees receive the same percentage of salary or wage reward although the actual dollar amounts vary.

Program coverage. Consideration must be given to those employees who are to include those who directly affect productivity, support people should not be to include those who directly effect productivity, support people should not be ignored. For instance, buyers may not directly affect the productivity of the unit, but if the materials are not available when needed or are not of the quality necessary to get the job done, productivity problems will result.

Program manipulation. Of course, the incentive program must be administered such that employees cannot gain without performing in the desired manner. The ability to manipulate the system is increased by the number of evaluators and the subjectivity of the measures.

Program communication,. It has been our experience that not enough time is spent communicating the essential elements of the incentive program to employees. According to expectancy theory, motivation will occur only if employees perceive a link between effort they exert and performance, and a link between performance and desired outcomes. The linkage between performance and productivity and rewards must be clearly

established if the program is going to be successful.

Problems of Success

Too often managers don't completely consider the ramification of an incentive program that works. Yet employees are going to realize that by becoming more productive they will be faced either with increased opportunity if there is an expanding market for the organization's products or services, or the number of employees needed will be reduced. Organizations that have fallen into the latter category must be able to assure employees that their jobs are secure. One U.S. organization provides a life-time employment guarantee for those individuals who can figure out ways to do away with their own job. When a reduction-in-force is required, this organization relies on attrition. In either case, employees must understand how additional production and efficiency will be handled or rate restrictions can result.

Although we have poined out a number of inherent limitations in merit pay programs and we believe that GIPs offer a viable alternative for linking pay to performance, organizational conditions will dictate which type of program will be most beneficial. In fact, these approaches are not necessarily mutually exclusive. Such incentive programs as the Lincoln Electric Plan have both group and individual rewards. Furthermore, there has been a movement in management theory and practice to reduce the discrepancies between blue-collar and white-collar employees. The "all salaried" approach is a popular management program designed to reduce this discrepancy by putting blue collar workers on the same salary schedule and by giving them some of the same benefits that salaried employees enjoy (paid absences, no time clocks, flexible schedules and so forth).

We believe that interests and values can be more closely aligned by including both groups in the same incentive program rather than by using the traditional merit approach for salaried employees and length-of-service or piece rate systems for hourly employees.

Finally, we suggest that more thought be given to the design and implementation of incentive programs for technical, professional, and managerial employees because these are the employee groups experiencing the fastest growth. With a productivity crisis facing our nation, improved job performance is a necessity. Regardless of one's individual preference — merit pay or group incentive program — rewarding performance and productivity is essential because as most managers are well aware, "You get what you pay for." □

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