New Reward II:
Issues in Developing a Modern Remuneration System

edited by Peter Reilly

Report 419

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New Reward II

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edited by Peter Reilly

IES Research Networks

Report 419

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Introduction

This report is the second collection of research papers on reward issues produced by the Institute for Employment Studies (IES). These were written over the last year or so as inputs to member events. We have brought them together under the theme of the so-called 'new reward' approach because they cover remuneration practices that are seen as part of this concept. This second report deals with:

- flexible benefits and total reward
- non-financial recognition
- market determined pay
- variable pay.

This introduction puts these practices in the context of the 'new reward' philosophy.

Definition of new reward?

It might be helpful to describe what is 'new reward'. The fullest description is offered by Schuster and Zingheim (1992). For these writers, new reward is characterised by being:

- strategic
- distinctive
- business aligned
- flexible
- performance driven
- integrative of the actions of employer and employee.

Strategic and business alignment should be the goals of all HR practices. If you believe that reward can a means of achieving competitive advantage, then the organisation's pay approach should be distinctive, not a follower of the latest fads and fashions. It must fit with the business drivers of your organisation. The requirement for flexibility in remuneration systems comes from the need to adjust to changing business circumstances.

Reward must encourage improved performance in a more competitive and challenging business environment. This can be achieved through behavioural change. Remuneration systems can send signals of which behaviours are consistent with improving employee performance and hence organisational performance. Achieving alignment between employee and organisational goals is seen as one of the means to achieve this.

Specific aspects of new reward

We have chosen to highlight certain reward practices because they fit with the aims of the new reward philosophy.

Flexible benefits and total reward

Schuster and Zingheim argue that flexible benefits are part of new reward precisely because they allow adjustment to changing business circumstances. They make this claim because they see traditional benefits systems as too 'tenure' related, providing fixed entitlements. They claim that flexible reward fulfils the strategic aims of cost control and performance improvement.

This seems a very US approach to flexible benefits, and possibly one that is rather outmoded. In the UK, the argument for flexible benefits is driven by the need to attract and retain staff. Providing flexibility in the benefits package and extending its scope is seen as giving a competitive edge in the 'war for talent'. It may be a relatively cost-effective way for employers to make their offering distinctive, especially in a world of choice and personalisation.

A refreshed description of new reward in the UK would take account of the era of tight labour markets and new generations of employees with different priorities and ambitions. Flexibility in benefits provision allows employees to tailor what they want to their particular needs and preferences.

The greater the extent of benefits on offer, the greater the need to sum together the content into a total reward statement. This can allow the employer to communicate the full value of the whole package on offer. Some organisations have gone beyond this and included wider aspects of the work proposition. This might recognise the intrinsic content of employment (the job satisfaction, the chance for development and the work environment). In other words, total reward can describe the psychological contract between the employer and employee.

Non-financial recognition

Non-financial recognition seems to have received the least attention from new reward proponents. Nonetheless, it can be argued that it is a natural extension of the total reward concept. This is because it emphasises the employee need for recognition of their contribution. This is a critical part of the psychological contract.

The importance of non-financial recognition lies in the fact that it gives emphasis to intrinsic, rather than extrinsic, motivation. It focuses on the non-monetary aspects of motivation.

One of the difficulties in tackling the subject of non-financial recognition is that there is no agreed definition of what it means. It covers a broad area from formal to informal mechanisms, from devices that are cost free to those that have some, limited, financial value. The fact that non-financial recognition approaches are cash free is vital, but also because the point is to offer a signal of esteem or approbation.

In the remuneration specialists' toolkit, non-financial recognition is a useful device for rewarding staff at little cost. For cash strapped companies, or public-sector organisations under cash controls, this can be very useful. This is especially true in the public sector where there is good evidence that intrinsic motivational factors are central to effective recruitment and retention. However, the real effectiveness of non-financial recognition comes from managers in their daily work giving praise as well as criticism, acknowledging efforts made, not just chiding staff about their deficiencies. That is an even bigger challenge than the remuneration one — getting managers to be skilled in the softer aspects of people management.

Market determined pay

Getting remuneration aligned with the market can be driven by cost-control reasons (reducing pay levels where they are excessive compared with the external labour market) or by recruitment and retention reasons (pushing up pay levels to attract and hold on to staff). The focus on the external labour market is a feature of new-reward thinking because it is more commercially attuned. It allows a response to changing business conditions and therefore can offer greater flexibility.

Traditionally, compensation has focused on internal relativities, especially in the public sector. A market-based approach would argue that such a view ignores the realities of whether remuneration is sufficient to attract, retain and motivate current employees and potential future recruits. If reward is to help offer something distinctively attractive in a tight labour market, then it should offer more than a 'vanilla, me-too flavour that provides no competitive advantage' (Lawler, 1990).

However, as the paper points out, often organisations are more concerned to match their competitor than offer something new. And, in some sectors, getting data to justify differences between locations or occupational groups can be a formidable task. As some of the proponents of market-based pay have discovered, these difficulties have led to a cautious rather than innovative approach to reward management. There is no sense in pressing for more cost-effective remuneration if the consequence is poor performance in recruitment and retention or a rising paybill. The former may happen if senior executives drive down wages too hard. The latter occurs if pay decisions are devolved precisely so that they are 'closer to the market', but line managers use their freedom to pay more, not less.

Despite these problems, remuneration does need to be to responsive to market signals. Organisations have to find the best way to respond that balances considerations of internal and external equity; that prevents risk of equal-pay challenges; that offers a system that can be reasonably managed and delivered, given the skills and resources available.

Variable pay

'Variable pay facilitates employee—organisation partnership by linking the fortunes of both parties' (Schuster and Zingheim, 1992). To new reward thinkers, variable pay is a means of sending a strong signal that employee livelihoods depend on the success of their employers' activity. Variable pay also offers flexibility, in that the paybill can rise or fall with business performance. This means that costs can be minimised during difficult trading periods, but employee incomes can grow during the good times. This is why variable pay is sometimes described as 'pay at risk'. The burden of financial responsibility is shifted to the employee, away from the employer.

Variable pay can also be used as a straightforward form of individual performance-related pay. Instead of (or in addition to) performance related pay being delivered via base-pay progression, bonuses can be offered. This has the advantage of giving a potentially large sum of money at one go and usually without increasing fixed costs, including having to cover the pension on-costs. Some payment-by-results and profit-sharing schemes can also be seen as forms of variable pay.

When variable pay works well it can offer clear incentives to deliver business results. The danger is that the link between effort and reward is insufficiently clear. Business results may be remote or disconnected from the individual's own contribution, as in some profit-sharing schemes. As a cost-effective way of delivering reward, variable pay has a positive future, but in terms of raising organisational performance, there needs to be careful scheme design.

Conclusion

New reward is in itself a fairly flexible concept and may have now run its course. Its principles though of aligning remuneration to business performance, the labour market and employee contribution, with flexibility to respond to changing circumstances, must be enduring. The particular techniques for doing this may vary over time. What this collection of papers emphasises, however, is that non-pay aspects of reward should be given due attention.

Flexible benefits, total reward and non-financial recognition all point to the importance of looking at wider aspects of the employment deal, in taking account of intrinsic motivational factors and of the other ways organisations need to attract and retain talent, through a package of benefits that meets their particular needs.

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1. Flexing your Remuneration: Variable Pay at Work

Paul Suff and Peter Reilly

Variable pay, sometimes referred to as 'pay at risk', is the portion of the remuneration package that has to be earned on each occasion, usually by meeting and exceeding individual, team or organisational performance criteria. As Schuster and Zingheim, (1992) put it: 'variable pay is any form of direct pay not folded into base pay that varies according to performance'. Bonuses, performance-related pay, profit sharing and team rewards all come under the variable pay banner. While the rewards from variable pay schemes can be substantial, employees are forced to shoulder more of the business risks — rewarding the 'upside' and penalising the 'downside' of performance. The relatively large potential rewards make variable pay schemes appealing to some employees, particularly in periods of low inflation when basic pay increases are comparatively small. Companies are particularly attracted to variable pay for senior executives because of both the potential incentive effect and need to be seen to reward only success. Executive remuneration has become a distinct form of reward and will not be discussed here. With respect to the rest of the workforce, employers increasingly see the benefit of variable pay in linking reward to performance and in promoting a common interest between staff and management. It is also attractive to employers because payouts — such as bonuses and profit-sharing payments — tend to be non-consolidated so they do not increase fixed labour costs.

Forms of variable pay have become a significant feature of remuneration practice in the UK over the past 20 years, but they are not a new idea. A 1928 study, for example, estimated that 64 per cent of US firms had introduced bonus and profit-sharing schemes (Balkom and Brossy, 1997). Incentive payments, such as piecework and productivity agreements were widespread in UK manufacturing industry for many years. The rationale for such rewards is the belief that people are motivated to work harder or in a different way in return for financial gain. By linking the reward to the achievement of a specific goal, such as improved productivity, employees' discretionary effort is channelled in that direction. Employees' support for such arrangements will last as long as a positive relationship exists between the expected outcome (the reward) and the performance (effort expended).

1.1 What is variable pay?

1.1.1 Definitions

> *'Variable pay is defined strictly as pay which does not become a permanent part of base pay.'*
>
> Armstrong, 1999

Variable pay systems, such as profit sharing, bind overall earnings to variations in corporate performance while incentives like bonuses link rewards to improvements in one or a combination of individual, team, unit or company performance. Under such schemes, employees shoulder an equal share of the risk with the employer; if the target is not achieved there is no payment. Variable pay is often a key component of the total reward package.

> At the Nationwide Building Society, for example, the remuneration mix consists of fixed and variable pay, and benefits. IRS (2004b) reported that the fixed element, which is made up of base pay and salary progression, accounts for 66.8 per cent of the overall spend, while benefits, such as allowances, healthcare and pensions, and variable pay, including bonuses and recognition pay, consume 22 per cent and 11.2 per cent respectively.

1.1.2 The different forms of variable pay

Variable pay systems are commonly divided into the following three main categories:

1. **Payment-by-results schemes**: such as productivity bonus and sales incentives, where a proportion of the employee's pay is linked directly to the level of output or business outcome.
2. **Performance schemes**: including individual performance-related rewards and team-based pay, where employees are encouraged to meet specific standards or objectives that are not necessarily linked directly to output but help the organisation achieve its overall business goals.
3. **Financial participation schemes:** such as profit sharing paid in cash or shares via some form of equity-based arrangement, where employees are entitled to a share of the organisation's performance or profits.

There is a further differentiation between the various forms of variable pay: employees can, in the main, directly influence the achievement of goals attached to schemes in the first two of these categories, but there tends to be only an indirect link between employees' day-to-day activities and the triggers for awards and payouts from schemes in the third category. Although Lawler (1990) suggests that a clear 'line-of-sight' should exist between what individuals and teams do and what they will get for doing it, the activities of employees have little direct influence on the achievement of corporate profitability for a profit-sharing award, for example. Another distinction is between bonuses paid after performance, which is a reward, and those offered in advance as an incentive. The latter is more popular and more effective, as such arrangements tend to have clear measures and be based on a fixed formula.

The three categories are not clear-cut. As variable pay schemes have become more sophisticated, they also tend to overlap, from one category into another. Fewer bonus schemes now focus exclusively on output, for instance; most cover a range of factors (multi-factor schemes). Although bonus payouts might be triggered by an increase in output, for example, there are likely to be quality and safety objectives attached to prevent greater production coming at the cost of poorer quality products and declining worker safety.

Payment by results

The classic payment-by-results (PBR) scheme is the traditional productivity incentive used in manufacturing industry to raise shopfloor output. Such schemes aim to motivate employees to exert more effort. According to Armstrong (1999), a PBR scheme must meet the following criteria for it to be effective:

- A clear and direct link between effort and reward
- The value of the reward is appropriate for the effort exerted
- Individuals are able to control their level of effort in order to earn the reward
- Rewards closely follow the effort
- Individuals are unable to manipulate the scheme to earn excessive rewards.

Although most PBR schemes are in decline, and have been for many years, some endure. The main ones are: piecework, measured day work and work-measured schemes.

- Piecework — a system where the level of pay is directly proportional to the level of output. As long as the rate is fair, piecework is relatively easy for employers to operate and for employees to understand. A fair rate is hard to achieve though: a rate set too 'low' or 'tight' will force workers to exert too much effort and they will eventually become dissatisfied and less productive; a rate set too 'high' or 'loose' will push up earnings and make the scheme too costly. Piecework is most appropriate in operations that are repetitive and require a largely unskilled workforce.
- Measured day work — a system that guarantees a certain amount of pay as long as a specified level of performance is maintained. The system has an in-built incentive element so that employees are under an obligation to keep output at the required level. Measured day work systems have been largely replaced by high day-rate systems, with additional multi-factor team or factory-wide bonuses.
- Work-measured schemes — a system based on work measurement techniques of time management to determine standard output levels in a specified period or standard times to complete tasks.

A different form of PBR is seen in sales incentive schemes. These can take the form of bonuses (the most popular according to IDS, 2000), commission and non-cash incentives (like extra holidays).

An average payout of 20 per cent of base pay has been reported (Thompson and Milsome, 2001). Sales staff typically have a low base pay and a higher variable element. Rates are very market sensitive and tailored to meet specific company needs.

Performance schemes

The majority of bonus schemes fall within this category as even the most basic are no longer tied exclusively to measures of output. For example, those that focused on sales growth alone may have broadened out targets to reduce the mis-selling risk. Team or company-wide schemes, such as multi-factor bonus systems, which generally combine both output and input factors and rely on a set formula to calculate awards are increasingly common examples of performance-based variable pay arrangements. Single-factor schemes, which focus on a specific objective, such as attendance, are also relatively popular.

Asda: All colleague bonus scheme

Introduced in 2000, Asda's all colleague bonus scheme is a single-factor, profit-related bonus plan that operates at a local level. The size of the bonus is determined by store or depot performance against its annual business plan and set profit target. The store's performance must meet a minimum level to trigger a bonus payout. If a store hits its business plan profit target, 90 per cent of the bonus is payable. If it exceeds its plan, the maximum that is payable is 120 per cent. The bonus period runs from January to December, with payment the following February. In 2004, the average payout was £226.73 but staff in the 156 best performing stores received 'superbonus' payments worth £300.

Although most performance schemes focus on improvements that are substantially within the control of employees involved, such as product quality and customer service, some combine such measures with broader organisational objectives, such as profitability, over which staff can exercise very little direct influence. Ideally, profit-related schemes should fall within the scope of the financial participation category, but the distinction is blurred by incentive schemes that are linked to broad business targets, such as profitability, but with payouts determined by individual performance ratings often based on an assessment of what a person achieves and how they achieve it. Some organisations attempt to retain the 'line-of-sight' link in bonus schemes that contain broad financial factors by including a business unit profit target or sales growth.

> In financial service companies (like the Royal Bank of Scotland) individual rewards largely determined by hitting business targets may be affected by performance on people management measures. The employee management dimension may reflect the results of upward appraisal or the scores from an attitude survey.

The three main performance-based arrangements are:

- Gainsharing — a multi-factor system based on a specific formula that allows employees to share in any financial gains and efficiency savings made as a result of improved performance. The formula determines how the gains are to be distributed between the company and its workforce. A common performance formula is the difference between selling price and employee costs. This enables the return to the company to be calculated directly.
- Multi-factor schemes — a system based on two or more factors of performance. Multi-factor schemes can operate at a local level, covering specific jobs, teams or departments with targets over which employees can exert some influence, or are company-wide or multi-level arrangements linked to wider business goals. Some firms use the same multi-factor schemes for different employee groups, but tailor the targets to suit specific jobs, functions or units. Multi-factor schemes can also be applied to individual performance (single level), so that the bonus award for each employee is based on their performance against a basket of factors. Another way several factors are used is by using one or two as threshold targets, *ie* these have to be passed before the incentivised targets can be accessed. For example, quality or customer satisfaction levels must be met before performance against output targets can be judged for a bonus.

> **Companies House: performance bonus scheme**
>
> Companies House revised its existing bonus arrangements in 2003. It retained a special review scheme, which rewarded exceptional individual performance and introduced a new performance bonus linked to 49 targets in three areas — customer service, and organisational and departmental performance — plus a productivity element. The new plan pays out annually on two different levels. A specified number of

points can be earned for each target, and the total earned determines one payment. A second payment is made if all productivity savings are realised, which can double the amount payable. Individual payments are based on annual earnings. In 2003-04, the bonus payments were between seven per cent and 13 per cent of base salary (Work Foundation, 2003).

B&Q: Store team bonus

The store team bonus was introduced in February 2003, replacing a profit-sharing scheme. Under the new scheme, employees receive a fixed payment of three per cent of salary every six months if company profit targets are met. There is also the potential to earn a further 6.75 per cent linked to store and company performance, plus a lump sum of £250 if customer satisfaction levels improve. Each quarter Gallup interviews 3,000 randomly selected customers and a customer service index (CSI) is compiled for each store. A store league, consisting of five divisions, ranks each one, with the top 20 per cent of outlets in the premier league. Rankings are re-calculated each month according to sales and stock-loss performance. If company profitability is 105 per cent of target, staff in the top performing stores (premier league) will receive the full 6.75 per cent in addition to the guaranteed six per cent annual profit-sharing payment, while staff in a division four outlet will get 2.25 per cent plus the yearly profit-related payment. The maximum variable bonus, including the CSI payment, is around 15 per cent. Under the old profit-sharing scheme, it was 12 per cent (Work Foundation, 2003).

- Team-based schemes — a system based on the achievement of team targets, and used primarily to reinforce a culture of teamworking and co-operation. Collective targets ensure the link between employees' performance and the bonus is clearly visible. Some employers favour team-based rewards because they believe peer pressure will ensure maximum effort from every group member.

Financial participation

The introduction in 1987 of tax incentives increased the popularity of profit-related pay (PRP) schemes. There were more than 14,500 Inland Revenue approved PRP schemes in 1997. Although the tax relief ended in 2000, profit sharing remains a popular way of motivating employees to increase their involvement in, and encourage closer identification with, the business and its performance. Such arrangements are also seen as a way of retaining staff.

The other main financial participation mechanism is the allocation of shares. Equity schemes also have tax advantages. Some profit-sharing schemes allow staff to choose between a cash award (or immediately selling their equity allocation to release cash) and putting the equity allocation in trust. The latter option means individuals will get the maximum tax benefits and there is also the potential that their allocation might increase in value.

- Profit-sharing — a scheme under which a cash or equity award based on organisational profitability is made to employees.
- Share incentive plan (SIP) — Inland Revenue approved scheme that allows companies to allocate up to £3,000 worth of shares a year to each employee. Employees can also buy up to £1,500 worth of shares a year. Companies can reward employees' financial commitment by giving up to two matching shares for one an employee buys. (SIP is also known as 'all employee share ownership plan' or 'employee share plan').
- Company share option plan (CSOP) — Inland Revenue approved scheme that allows companies to grant up to £30,000 worth of share options each to any number of employees.

1.1.3 Design choices

There are number of different ways of setting up a variable pay scheme. The key choices are described below:

- **Coverage** — is it to be an inclusive scheme covering all employees or exclusively designed for certain groups?
- **Focus** — is it to be a scheme based on the performance of individuals (*eg* through individual performance related pay or PBR) or teams?

Barclays Group: Performance incentive plan (PIP)

Introduced in 2000, the PIP covers all employees except the executive committee and staff in the company's investment banking division. A bonus pool is generated each year if the bank meets or exceeds its annual targets for economic profit (EP) — the bank's total capital assets multiplied by the net return on investment, minus the costs of capital. The bonus pool for most employees is made up of 25 per cent performance against EP and 75 per cent for the performance of their own business unit.

EP targets are described as stretching, and staff are expected to do more to earn their bonus each year. Individual payments are determined by employee performance ratings against the achievement of personal objectives, and can range from zero to 50 per cent of salary. Typical payments for junior staff are between seven per cent and 15 per cent, and for senior staff they are between 20 per cent and 35 per cent (Work Foundation, 2003).

- **Uniformity of design** - are there different schemes for different business units or functions or a single mechanism for all employees involved?
- **Type of reward** — is it to be an incentive or recognition scheme, *ie* are you trying to encourage performance change through the use of a financial carrot or offer a post hoc recognition of staff contribution?
- **Type of performance measures** — is it to be a focused scheme based on single performance factor or based on a number of factors? Are they a mix of individual and team-based measures, a mix of short- and long-term performance targets?
- **Form of review** — is the scheme to be based on some form of managerial assessment of performance (*eg* through an appraisal) or automatic in the sense that performance against targets is obvious (*eg* productivity or sales)?
- **Type of measures** — are these to be soft (*eg* behavioural) or hard (*eg* output-based)? The former will need managerial assessment. Are the measures against an absolute standard or relative, *eg*:
  - Comparing one team against another (eg shift or operational teams) doing the same job but at different times or in different places but in the same business unit?
  - Comparing one team against other teams in other business units in a multi-company group?
  - Comparing one team against an external benchmark, *eg* a national standard of performance?

1.2 Why introduce variable pay?

1.2.1 Overview

In their 1992 book, Schuster and Zingheim give pride of place to variable pay. It is the 'centrepiece' of the new approach to reward. This is because it 'facilitates employee-organisation partnership by linking the fortunes of both parties'. Their emphasis is on the linkage between reward and business strategy, a key element in 'new reward' thinking (Reilly, 2003). Variable pay achieves this by reflecting a common purpose for the organisation. However, as recent UK research has shown, organisations have other objectives to be met through this form of remuneration.

A survey of 365 organisations by the Work Foundation (2003) found five common reasons and aims for introducing a bonus plan (Table 1.1).

IDS (2003) found that performance criteria for bonus schemes cover a wide range of factors, including:

- productivity and output
- quality
- safety
- financial performance/profits
- cost management
- sales
- customer service/satisfaction

Table 1.1: Why did your organisation introduce its bonus scheme(s)?

Objective	%
Improve business performance	67
Create a direct link between employee and corporate performance	60
To recognise and reward achievement	58
To help motivate staff	56
To focus employees on specific objectives	50

- attendance
- HR-related measures (*eg* training and development or employee morale)
- project work targets
- teamworking
- individual performance.

Some of these factors reflect the higher level goals listed earlier, but some are more specific aims of a cultural or people management kind.

> An example of variable-pay targets relating to people management measures is to be found at Great Eastern Hotel. There, managers have employee development targets to meet. At DeVere Belton Woods Hotel the team managers' bonus is linked to results of the employee opinion survey, as well as completion of the induction and departmental training programme within the allotted time (IDS, 2003).
>
> RBS managers also have a proportion of their bonus related to a measure of employee engagement.

Cost control and flexibility

The increasingly competitive business environment has made it essential that organisations control their costs. One of the biggest costs to an organisation is its expenditure on labour, so controlling the size of the annual pay budget is an important goal of many reward strategies. General, across-the-board uplifts in base pay increase fixed labour costs year-on-year without changes in employment levels. Awards made under variable pay systems do not increase fixed labour costs, as they tend to be non-consolidated payments.

Variable, non-consolidated awards are especially important in an era of low inflation because fairly large rises in total pay can be accommodated without incurring substantial additional fixed costs. Performance-linked bonuses, for example, can significantly boost earnings and therefore help maintain motivation and commitment during a period of relatively low inflation, when it is difficult to differentiate between individual levels of perfor–mance in base pay terms.

The balance between base-pay increases and variable pay awards is illustrated by recent awards at First Direct, the telephone banking subsidiary of HSBC. IRS (2004a) reports that staff received a three per cent basic increase in pay from April 2004, but that bonus payments, which are based on a combination of personal and corporate performance, were worth up to 16 per cent of salary.

And because variable pay is non-consolidated, it also has cost-containment advantages over some other performance-linked rewards. There is evidence that the motivational impact of individual performance-related pay declines over time and, because most merit pay awards are consolidated into basic salaries, pay levels do not decline in conjunction with performance. This means that merit pay arrangements can ratchet-up fixed costs without performance benefits. Non-consolidated performance-linked payments, such as bonuses paid as a percentage of base salary, are often attached to merit pay schemes. The rationale for this is that, not only are fixed costs controlled, but also individual performance improvement can be improved. In addition, employees can be incentivised to enhance their performance with a potentially large one-off payment.

Variable pay systems are also more closely related to employers' ability to pay, allowing the pay bill to adjust more quickly to changing economic circumstances. As Abosch (1998) points out:

> *'Variable pay allows the organisation to shift increased compensation from the fixed-cost to the variable-cost category, paying out only when the money is there to allow a layout.'*
>
> Abosch, 1998

Variable pay therefore provides the necessary flexibility in the overall remuneration mix, allowing payouts to be scaled up or down depending on business circumstances as well as reward different levels of contribution and performance.

One manufacturing company uses a form of PBR in its warehouse area. For employees this represents 40 per cent of pay — a significant proportion. From the employer's view, the benefit is that costs are held down and more closely related to activity. When output is down, so is the pay bill.

Flexibility can also relate to changing labour market conditions: organisations can more easily increase or decrease the variable element of remuneration, compared with base pay. If there is a lot of competition for labour additional potential earnings can be made available. If the labour market is slack, variable pay can be reduced.

Business strategy

> *'The only significant purpose of a reward strategy is to facilitate the attainment of organisational objectives and to support organisational strategy.'*
>
> Greene, 1995

Rewards play a significant role in helping organisations achieve their goals because they can focus employee attention on what matters and can help to change behaviour. Incentives, such as bonuses, focus attention on what needs to be done to receive an additional payment.

> Getting employees to focus on what is vital in terms of business success can be achieved through variable pay schemes. For example, profitable sales are key rather than simply sales volume (Corkerton and Bevan, 1998).

Such arrangements usually have a short-term time frame and tend to be based on specific 'line-of-sight' financial and operational measures, with frequent payouts ranging from one month to one year.

> The store-team bonus scheme operated by DIY retailer B&Q is based on levels of customer service and shrinkage (stock wastage and theft) and provides a clear 'line of sight' between what staff do, how they behave on a day-to-day basis and a store's financial performance. As reward manager Will Astill explains:
>
> '*[Staff] can increase profits by cutting costs, such as shrinkage, as well as increasing sales. And [staff] might be able to encourage a customer to buy something, but if they don't have a good experience they won't come back*.' (Work Foundation, 2003)

Longer-term incentives — which typically involve the allocation of shares that can either be cashed in or, to enjoy the full tax benefits, be placed in trust for at least three years — tend to be linked to broader organisational aims, such as improving employee commitment and loyalty or, in executive schemes, to long-term business performance.

Tesco's 'shares in success' scheme awards staff with at least one year's service with free shares most years. They can choose to either keep their allocation and place it in trust to mature for three years or cash it in. In 2003, 75,000 Tesco employees shared £38 million worth of shares. The value of the shares, which were worth 184 pence when allocated, increased by 31 per cent over the three-year period. According reward manager Richard Sullivan, Tesco's share schemes help to retain and motivate staff:

'The key rationale for our share schemes is to offer all employees a real share in the business and to increase their commitment as stakeholders in the company.' (IRS, 2001)

1.2.2 Cultural change

Some organisations use variable pay to effect cultural change. Research suggests that generating a more performance-orientated culture was a key feature of the interest in early individual performance-related pay schemes (Kessler, 2000). Public-sector organisations are currently trying to use variable pay in this way: to move from a culture of simply turning up to work to engaging in its success.

Getting a better understanding of business may be a help in this regard. So, schemes that describe the nature of effective performance and emphasise the link to business success may be chosen precisely with this educational point in mind. The examples given earlier of a shift from individual to team focus, from revenue to profit, show how variable pay schemes can we used to re-orientate people to new business goals or, as likely, to responding to existing goals in the proper manner.

1.2.3 Recruitment and retention

Offering variable pay as part of a remuneration package to attract staff may be done for offensive or defensive reasons. Taking the latter, if bonuses or profit sharing is the norm for that sector, occupation or salary level, then employers are bound to offer the same so that they will not be at a disadvantage. Clearly, if it is not usual in these circumstances, an organisation offering something more may gain competitive advantage. The benefit from the employer's view is that this extra element may, if properly designed, be funded from extra income. In some circumstances, affordability might drive the proportion of variable pay in the package and its nature. Many dot com companies could not afford high wages and so offered shares linked to business performance instead.

If the reasoning behind the variable pay scheme is to emphasise inclusivity — we are all part of a common organisation — then the possibility of extra cash or shares may also have a symbolic value. It may form part of the employer's brand, a signal to the market of what the organisation stands for. The Tesco example, given above, and the Royal Mail illustration (below) might be seen in this light.

Royal Mail's corporate bonus scheme

The Royal Mail's 'share in success' scheme is, at the time of writing, set to deliver a bonus of between £800 and £1,000 if the company's profit exceeds £400 million in the financial year to end March 2005.

A company spokesperson described the scheme as being 'part of making Royal Mail a great place to work and recognising the hard work everyone is doing to turn round the company' (reported in the Guardian, 8 November, 2004).

Critics have complained that though revenue targets may be met, service quality targets have been missed.

With respect to retention, variable pay can put more money into the hands of the best performers, something that is increasingly important as organisations compete for the most talented individuals. Highly differentiated performance-related pay schemes can do so by giving bigger bonuses to the top performers and smaller (or no extra money) to the average or merely 'good' performers. Companies can find a twin benefit in such an approach: the best get more money and a signal that their contribution is recognised and valued. Channelling the highest payments towards the best performers in this way helps to retain the most effective people.

1.2.4 The broad thrust of benefits

We have already highlighted the main practical organisational benefits for implementing variable pay schemes: cost control and flexibility, and the increasing need to integrate rewards more coherently with business strategy and for recruitment / retention and cultural-change reasons. In a broad sense, there is a distinction in the objectives behind variable pay schemes. According to Hyman and Mason (1995), employers may have idealistic (promoting equality) and instrumental (improving employee performance) reasons for introducing financial participation schemes. The John Lewis Partnership, where all equity is held in trust for the benefit of permanent staff, provides an example of the first approach. Variable pay schemes, such as bonuses, that pay out relatively quickly following the achievement of targets, tend to focus employees' efforts on specific instrumental benefits, such as improving attendance, customer service, quality and safety.

> The gainsharing scheme operating at BP Grangemouth, for example, is designed to encourage key measures within the employees' performance contract and to reward them for achievement of those objectives (IDS, 2003).

Nisar (2003) says the key business objectives relating to the introduction of bonus arrangements are, in fact, made up of a mix of instrumental and idealistic reasons and include measures to:

- support stakeholder ideals by allowing employees to share in the success of the business.
- encourage change within the organisation.
- create the desired workplace culture by, for example, rewarding teamwork and good attendance.
- influence the wider market by creating a good reputation among prospective employees and customers.

Leadbetter (1997) has outlined six main organisational benefits from profit-sharing schemes:

1. Co-operation — financial participation creates a common interest between workers, employers and shareholders, which reduces conflict and 'us and them' attitudes.
2. Productivity — giving employees a stake in the business helps to raise productivity, improve quality and promote a culture of continuous improvement.

3. Patience — employees are more knowledgeable about the company and tend to be more patient than external shareholders, so there is less short-termism.
4. Loyalty — employees are more committed and there is less labour turnover and absenteeism.
5. Flexibility — employees understand the need for rewards that match the ups and downs of company performance.
6. Risk taking — employees understand the nature of the risks taken by owners of capital and how markets work.

Some of these benefits could be construed as driven by idealistic motives, but all could be said to have an instrumental element to them. Inducing loyalty may be a good thing in itself, and it can also lead to organisational benefits in terms of greater employee engagement. It could be argued that schemes only driven by an idealistic approach are not really forms of variable pay. Certainly, this is true if free shares are issued without any performance criteria.

1.2.5 Choosing type of scheme

The choice of variable pay system will depend on the main aim of its introduction. Driving up individual rather than team performance will lead to individual performance-related pay rather than team-based pay, or vice versa. One high street retailer, for example, switched between mechanisms as the business demands altered.

Continuous improvement in the quality of the products and services might need a different model than one where a short term hit is required to shift performance. For example, one organisation wanted to use team-based pay to tackle a backlog of orders that were not getting sufficient attention. By contrast, a profit-sharing scheme might be more suitable if the objective is to stimulate employee interest in company business performance and develop a greater sense of loyalty. Developing an increased sense of corporacy might lead to a similar scheme re-design. One company altered its variable pay arrangements to emphasise business unit interdependence instead of independence.

As we have remarked earlier, a long-term focus can be obtained in a share scheme where the shares are put in trust. Allowing immediate disposal of shares will only encourage ways of boosting the share price in the short term.

1.3 Evidence of success

1.3.1 Recognition schemes

The best researched variable pay schemes are those with some form of profit sharing involved. For a full review of the evidence refer to IES' report, 'A Share of the Spoils' (Reilly *et al.,* 2001).

In truth, the evidence for the success of profit-sharing schemes is mixed. Some research shows that companies with share schemes outperform those without on their share price or, even more broadly, profit-sharing companies do better than the non-profit sharers on a wide range of business performance measures (including measures of profit, growth and investor returns).

There are, however, dissenting voices who have found no positive link between employee financial participation and profits, or only a limited and confused link. For example, Bryson and Millward reported in 1997 that share ownership had no significant effect on company performance. Poole and Whitfield (1994), looking at several measures of economic performance, found that there is no discernible relation between any financial participation schemes and gross return on capital.

Moreover, some schemes seem to have failed to engage staff, whilst other research claims a positive reaction from companies. Poole and Jenkins (1990) found that only 15 per cent and 17 per cent of employees respectively agreed with the following statements: 'profit-share schemes have successfully increased employees' sense of commitment to the company' and 'profit-share schemes have successfully made employees feel part of the company'. By contrast, Sloan and Jackson (1996) reported that 57 per cent of companies said their profit-sharing schemes matched expectations, while 60 per cent claimed the same for their profit-related pay arrangements.

One has to be careful with such evidence since there is a difference between employee and employer perceptions of success. Self reporting of results by organisations may give the impression of better performance than is really true.

In this debate over the effectiveness of recognition schemes the middle position is that the better performing companies are likely to be those who think more about how to reward employee contribution and link it to business outcomes, which in turn further builds financial success. Viewed from this position, inclusive forms of variable pay may be part of the 'bundle' of people management policies and practices that leads to employee engagement and improved performance. So schemes that recognise employees' contribution when combined with such things as employee involvement in work decisions, appropriate task discretion and the encouragement to train and develop skills are likely to be most effective. See Tamkin *et al.* (2004) for a review of this research.

1.3.2 Incentive schemes

The evidence that bonuses produce the desired benefits is slightly stronger. The Work Foundation (2003) survey found that more than three quarters (76 per cent) of respondents rated their bonus scheme as either 'very' or 'quite' effective in meeting organisational goals. IDS (2003) reported on bonus schemes in 30 organisations. Most employers were positive about the impact of their bonus arrangements. For example, Marks & Spencer, which operates a store-based arrangement that focuses on sales growth as well as motivating and retaining staff, told IDS that employee feedback on the scheme revealed increased motivation and team spirit. TRW Systems, which uses a gainsharing scheme at its Peterlee site, also says employee motivation and morale have improved, and levels of non-attendance have declined. Note though that these are organisations reporting their own success and companies tend to be effusive about their own schemes. Presumably only those schemes that do work are retained. It does not tell us what type of schemes fail or about the conditions for success.

More helpful is research by Weitzman and Kruse (1990) that suggests that such arrangements are only successful where the culture supports the achievement of its performance targets. Specifically, they found that bonus schemes are more likely to boost productivity where there is also a culture of employee participation and where the payout represents a sizeable share of employees' remuneration.

1.4 Prevalence of the variable pay schemes

Variable pay has changed significantly from traditional arrangements like piecework, but continues to be a major feature of many reward strategies — yet in a different form. The latest reward management survey from the Chartered Institute of Personnel and Development (CIPD 2004) reveals that almost half (49 per cent) of the 560 employers polled award annual cash bonuses, while four-in-ten offer share schemes. The popularity of variable rewards, for both senior staff and other employees, is linked to a combination of factors, particularly the need to control fixed pay costs and increase pay flexibility, and to integrate rewards more coherently with business strategy.

Over the years, traditional manual PBR schemes have declined amongst manual workers as pure production targets have fallen in the face of the emphasis on timeliness, quality and flexibility. By contrast, the number of white collar PBR schemes have grown, perhaps driven by the expansion of call centres (Thompson and Milsome, 2001).

Although various studies reveal that some forms of variable pay are more popular than others, there is ample evidence that the concept of putting some employee remuneration at risk is one that is gaining support. A study by Towers Perrin (1997) forecast increases in variable pay for all employee groups over the following three years, so that by 2000 it would have made up 26 per cent of senior executives' remuneration; 17 per cent of managers' and professionals'; seven per cent of clerical employees'; and eight per cent of manual employees'. Now Towers Perrin (2004) claim:

> *'Employers around the world have stepped up their use of variable pay in the last two years.'*

Surveys of this kind tend to exaggerate future take-up — it is in their interests to do so. Nevertheless, there is a range of evidence to suggest that companies are increasingly interested in variable pay. As we showed earlier, there is good reason to believe that this interest will be sustained: the business benefits are substantial.

The Work Foundation (2003) found that 77 per cent of the 365 organisations it polled operated a bonus scheme for all or some of their employees. The latest IRS (2004c) annual survey of pay trends shows how some variable pay schemes are gaining in popularity, while others are becoming less common. Of the 297 organisations participating in the IRS survey, 57.9 per cent have a cash bonus scheme in place — the second most popular reward strategy after merit pay; nearly a third (31.6 per cent) use employee share schemes; almost a quarter (24.2 per cent) use incentives payments, such as sales commission; and a similar proportion (23.6 per cent) operate a profit-sharing scheme. Gainsharing, however, is rare with only two per cent of surveyed organisations currently using it.

The most recent CIPD reward management survey revealed how widespread variable pay is by occupational group (CIPD 2004). It found that in 42 per cent of organisations, at least four-fifths of senior managers receive a variable pay element. Across other occupational groups, this is the case in 34 per cent of organisations for middle and first line managers; 24 per cent for clerical staff; and 15 per cent for manual employees. Public-sector participants distort these overall figures, however. Variable pay tends to be used more in the private than the public sector. Stripping the public-sector respondents out of the CIPD figures, reveals that 70 per cent of private-sector firms offer variable pay to senior managers and 40 per cent in manufacturing industry do so for manual workers.

1.5 Problems and potential pitfalls

1.5.1 Motivational theory

Variable pay schemes, such as bonuses, are based on the notion that people will work harder for more money. Yet, long ago McGregor (1960) pointed out that:

> *'The practical logic of incentives is that people want money, and they will work harder to get more of it. Incentive plans do not, however, take account of several other well-demonstrated characteristics of behaviour in the organisational setting: 1. that most people want the approval of their fellow workers and if necessary they will forego increased pay to obtain approval; 2. that no managerial assurances can persuade workers that incentive rates will remain inviolate regardless of how much they produce; 3. that the ingenuity of the average worker is sufficient to outwit any system of control devised by management.'*

McGregor was referring specifically to payment-by-results schemes, but much of his criticism is valid for contemporary variable pay arrangements, especially the argument that intrinsic rewards, such as peer approval, can be more powerful and longer-lasting motivators. Modern variable pay schemes also suffer other problems and potential pitfalls. To a greater or lesser extent, the general condemnation of reward programmes by Kohn (1995) applies to variable pay schemes:

- Rewards punish — Kohn claims that punishment and reward are 'two sides of the same coin'. Rewards are ways of controlling employees because they are contingent on a certain behaviour and are thus likely to be viewed as punitive in the long term. Moreover, people very often do not get the rewards that they were expecting, so they feel punished.
- Rewards rupture relationships — effective teamwork is undermined by rewards that create competition and, therefore, destroy co-operation. Relationships between superiors and subordinates also suffer because employees are likely to hide problems and/or 'curry favour' with the 'incentive dispenser'.
- Rewards discourage risk-taking — creativity suffers because people tend to play safe to make sure of receiving the reward. 'Do this and you'll get that makes people focus on the *that* not the *this*.'
- Rewards ignore reasons — rewards distract employees and organisations from discovering the root causes of problems. Kohn quotes the quality guru Deming and his criticism of performance-pay systems to suggest that no business can regard itself as a 'quality organisation' if it relies on incentives.
- Rewards undermine interest — artificial incentives tend to impair intrinsic motivation. This is because employees will think about what they earn, rather than the job itself.

1.5.2 Effort bargain

The tenuous link between individual or team performance and profitability is a major disadvantage of variable pay schemes that are linked to such measures. Profit sharing, for instance, is too remote from the actual performance of most employees; or to apply Lawler's concept, the 'line-of-sight' is blurred. IRS (2003) quotes a respondent at healthcare manufacturer Wrafton Laboratories, who said that 'unless there is clarity about how an individual can make a difference to business performance and profit, the cost does not have a matching proportional benefit.' A related problem is that profit-based payments are usually made on an annual basis, so there is no immediate reward for good individual performance. Too large a gap between effort and reward can minimise the effectiveness of many variable pay schemes because of the reluctance to make payments on anything other than an annual basis — for reasons of cautious financial management.

The other major problem with profit-related and other schemes is that external factors outside the control of the workforce, and, occasionally, the organisation itself can adversely affect profits (or any other externally determined measures) irrespective of the work and effort expended by employees. Such schemes, especially when initial payouts are relatively high, raise expectations among staff that they will receive similar amounts if they continue to work as hard and as diligently. A reduction in, or the absence of, a profit share payout one year because of external circumstances or mistakes made by senior management, can seriously damage employee motivation and commitment.

One distribution company found that their incentive scheme fell into disrepute. Employees were not comfortable with the measures and did not trust the data gathering process, but the main problem was that the scheme no longer paid out.

The Work Foundation (2003) reported that the LG Philips Displays plant in Durham has been operating a gainsharing scheme since 1992. Maintaining employee interest in the plan has become harder because payouts have declined over the years due to product changes that mean staff find it more difficult to achieve output levels.

Share-based schemes are also at risk of events outside the control of employees, which may limit their potential to alter staff behaviour and attitudes. Suff (2003) reported on the impact of collapsing share prices in many technology and telecommun–ications companies and how the 'profits' on the share options given to Marconi employees in the late-1990s were rendered worthless.

Badly designed bonus schemes may also not meet employees' expectations through no fault of their own or lack of effort. Lack of work, a shortage of materials, bad weather or a breakdown in machinery/technology, for example, can scupper employees' achieving a specific target. An evaluation of the trial of a multi-factor, team bonus scheme at HM Customs and Excise revealed a fall in staff morale in teams believing external influences were preventing them meeting their incentive targets (IDS 2003). The same concerns were expressed in the NHS trial of team-based pay (Reilly, *et al.*, 2004).

Another complaint is that the reward is insufficient for the money involved. This is a calculation employees will make both in terms of the strict effort-outcome bargain, but also in terms of the absolute level of reward. If the sum of money is substantial in the employee's own terms then it will more motivational than if a) it appears small, relative to their base pay income or b) the money can more easily be earned in another way (*eg* through overtime).

Fairness

Issues regarding the fairness of variable pay schemes overlap with the effort bargain and the reward on offer. Schemes will be judged unfair if:

- they are open only to a small proportion of employees, such as senior staff
- rewards are greater for some (often more senior) staff than others
- targets are skewed towards particular groups
- they do not reflect real performance or they do not reflect differences in performance.

Complaints about scheme inequity may derive from a lack of scheme transparency. The decision-making process may be opaque or it may be that the performance metrics are open to challenge. This is particularly problematic in process-based schemes: where does one bit of the process end and another start? Similarly, where costs and income are internally transferred, on what basis does this happen? It can be a matter of politics, financial management or administrative convenience how this is judged but it may impact on the success of scheme participants. Poor quality or contested data can destroy the credibility of variable pay arrangements.

Felt unfairness may be reported in schemes that are inclusive but are really designed for a particular group of staff. For example, in a retail environment, performance bonuses may be introduced for shop floor sales assistants, but for reasons of equity are extended to back office staff. Rather than feeling positive because of their inclusion, these employees may feel disgruntled because they have no real involvement in the targets.

Fairness is also a problem in other team-based schemes. Team rewards tend to ignore individual effort and contribution, relying on peer pressure to ensure consistent performance across the group. However, the lack of an acknowledgement of individual performance may demotivate those who thrive on receiving recognition for their own contribution. Research by Roffey Park (Holbeche, 1998), found that given the option employees preferred bonus arrangements that recognised individual achievement over team performance. It is likely, though, that employee preferences will depend upon their work activity and how it is undertaken.

By the same token, too much emphasis on individual contribution may undermine teamwork. Where bonuses payments and profit share allocations are unequal and determined by an assessment of individual performance there is the potential for some to view the process as unfair. Nisar (2003) notes that in the banking industry:

> *'… interbranch differentials in bonus payments tend to create numerous disparities and hence motivational problems.'*

More detail on issues concerning team-based pay can be found in the IES report 'New Reward I: Team, Skill and Competency Based Pay' (Reilly, 2003).

Perverse results

Performance targets that are linked to reward will encourage employees to pursue the behaviour and actions that trigger the payout often at the expense of other, equally important, business objectives. Hope (2004) reported that in a study by the Institute of Customer Service at Aston University Business School, which examined how 22 organisations rewarded and recognised the performance of their customer-facing staff, the majority used performance-related pay, including bonuses, to encourage staff to make as many transactions in a short a time as possible. This was sometimes regardless of customer satisfaction. For example, there was a three-minute customer time limit in one contact centre, which encouraged staff to terminate calls in mid-transaction.

> An international company found that its reward system was driving the wrong behaviours in its HR shared services centre. Reward was based on customer metrics: the happier the customer, the bigger the pay out to the service centre staff. This had the effect of staff going overboard helping customers even in violation of their own procedures.
>
> For example, payroll adjustments were made manually after payroll deadlines. This meant that subsequent adjustments had to be made involving extra work and risking errors.

Attendance bonuses are popular in some parts of the economy as firms try to reduce persistently high levels of non-attendance. Improving attendance by offering incentives, as the Royal Mail does, for example, should, all things being equal, also improve productivity because more people are at work. But if employees continue to come to work when they are genuinely ill, there is unlikely to be any improvement in their productivity or performance.

The term 'presenteeism' has been coined to describe health-related performance loss while working, and which is often the outcome when individuals who are ill still come to work. There is also the possibility that colleagues will become ill.

Unachievable performance targets or targets that move can also create problems as staff will disengage from the process. Failure to achieve targets resulting in low or no bonuses may cause the retention problems the scheme was designed to address.

This is particularly true if a market competitor arrives with a pay system that is more reliant on base-pay remuneration. Why would employees stay if that can guarantee their income elsewhere compared with a higher risk in a company that relies more on variable pay?

Self-financing?

One of the main attractions of variable pay to employers is that costs are controlled because they assume that these schemes are largely self-financing. This is not always the case. Administering such arrangements is often time-consuming because of their complexity. Boots the Chemist admits that its 'mystery customer report' bonus scheme, which was introduced in 2002 and focuses on both individual and store performance, cannot only make some employees feel 'under the microscope', but is not necessarily self-financing because undertaking mystery shopper reports and analysing the data is costly.

Variable pay schemes may prove costly for other reasons too. Team-based schemes may hinder the organisational flexibility that can help improve cost-effectiveness. People in cohesive, high-performing and well-rewarded teams may be unwilling to move, and it could be difficult to reassign work between teams or to break up teams in response to developments. The converse may also occur, with employees wanting to transfer to teams receiving the higher rate bonus.

The converse may also happen if payouts are deliberately separated from performance against the task, when the time comes to make the payment, the finances may be such that there is no money to disburse. This situation has happened in executive schemes where the gap between performance and reward may be longer than in general schemes.

In gainsharing and other team-based schemes, it may be hard to isolate the gains made from improved employee or group performance and those emanating from investment in new technology, for example. Under such circumstances, the scheme may be, as Armstrong (1999) points out '… no more than a method of handing out money without measurable return'.

Brown and Armstrong (1999) describe such an example at food processing plant, which had operated a gainsharing scheme for 20 years:

> *'Payments had steadily increased over the years simply because the payment formula had never been adjusted to take account of the regular improvements in the speed and reliability of the machinery'.*

Litigation

Attendance schemes risk being challenged as discriminatory because they may unfairly deal with the disabled (Reilly *et al*, 2004). There have been cases where schemes have been legally challenged because attendance has formed the basis of deciding whether an individual should share in a team-based payout.

Individual performance-related pay bonuses should be monitored to check that rewards are not discriminatory by gender, ethnicity or disability. If such problems occur, this may be due to flaws in the design or to failures in implementation.

Care also needs to be taken if some groups get some rewards and others do not. Local government is wrestling with this problem with respect to male manual workers getting performance bonuses, not open to females doing equivalent work.

Limited lifespan

Most bonus schemes are initially very effective at focusing employee behaviour on what needs to be achieved to trigger the payout. Armstrong (1999) says that his experience of introducing incentive schemes is for productivity to rise substantially when a scheme is first introduced, but that the level of increase tends to taper off. BP Grangemouth, which — as was noted earlier — operates a gainsharing plan and has done for many years, admits that changes to behaviour were more apparent in earlier versions of the scheme (IDS, 2003). Initially, such arrangements provide employees with a new challenge as they search for ways of improving performance in the selected target areas in order to secure the bonus payment. Ideas for cost savings, for example, will be reasonably easy to identify in the initial stages and payouts are likely to be reasonable high. But, as improvements become harder to find, so the level of payments will fall. Employee expectations based on high initial payouts will not be met, leading to less support and less engagement with the gainsharing scheme.

Summary

Curiously one can conclude that schemes can work too well or not well enough. They work too well if they produce:

- larger payouts than expected for employees (at the cost to the organisation).
- too much attention to the targets causing a 'displacement' effect, *ie* other non-bonusable activities get neglected.
- perverse behaviours from the overall organisational perspective. This happens when the targets are too closely followed and employees react understandably in terms of the scheme's logic.

They do not work well enough where there is:

- a lack of staff engagement in the scheme (*eg* because the reward is insufficient).
- demotivation amongst participants, *eg* if targets keep being missed.
- a challenge to the design, either because the whole concept is seen as flawed or, less seriously, the particular design is seen as ineffective.

1.6 Criteria for success

Overcoming all or some of the problems and pitfalls commonly associated with one or all types of variable pay is not easy, but where such schemes are relatively simple and well designed and managed they can motivate employees to improve performance.

The following success criteria may be used to judge the effectiveness of the design, introduction and management of variable pay schemes:

- Clarity of purpose — what is the scheme attempting to do?
- Alignment — with the business model so that the scheme sends the right signals to employees about what is important.
- Leadership — senior management commitment to the scheme's principles and intentions.
- Integration — with other remuneration and HR policies.
- Balance — the scheme does not succeed at the expense of other important business practices.
- Segmentation — where appropriate, to meet the differing needs of different groups.

- Affordability — payouts are not jeopardised by lack of money.
- Manageability — capable of being delivered (after training) by the current set of managers.
- Involvement — line managers and employees are party to the scheme's design.
- Suitability — simple, objective and achievable, but stretching, performance targets.
- Trackability — capable of being monitored regarding progress against targets.
- Revisability — subject to evaluation and periodic refreshment.

A scheme that really motivates employees will be one that generates a demand among them for information about individual, team and corporate performance. However, all variable pay schemes have a shelf life, and regular monitoring to ensure they are still achieving their goals is a prerequisite for continuing success.

1.7 Conclusion

Variable pay is increasingly being used by employers to shift some of the business risk to employees, so they receive a potentially large payment when times are good but only their base salary or a reduced additional payout when times are not so good. It provides firms with flexibility to alter rewards in line with business circumstances. Variable pay is particularly popular among employers because they can reward good performance without incurring additional fixed labour costs. And, by linking payments to the achievement of specific goals, organisations are better able to align remuneration with business strategy.

However, there are a number of potential problems and pitfalls associated with variable pay schemes. Where there is a clear line-of-sight between employees' behaviour and day-to-day activities, and they can directly influence the achievement of performance targets, employees' performance generally improves, at least initially. Where the line-of-sight is blurred and their actions have only an indirect influence on the outcome, a variable pay scheme may have little impact on employees' day-to-day performance.

All variable pay schemes have a shelf life, having less and less impact on employee performance. Ones that endure tend to alter significantly over the years, so that employee interest and enthusiasm is maintained and the performance targets continue to reflect business priorities.

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2. Non-Financial Recognition: The Most Effective of Rewards?

Michael Silverman and Peter Reilly

2.1 Introduction

For today's organisations, the problem of how to effectively motivate staff is becoming an increasingly important issue. However, despite over 50 years of organisational research that demonstrates that employees are motivated by more than money alone, many organisations continue to rely solely on financial rewards. It is perhaps understandable for organisations to make simplistic assumptions about the ability of financial rewards to influence employee motivation. Financial rewards are important as a mechanism to aid recruit and retain talent, and as a means of providing tangible recognition of effort or contribution. And after all, people generally want more money, don't they? Yet, the consequence of such an assumption has been to overemphasise the importance of financial reward. As this chapter will illustrate, there are a whole host of alternative motivators that can act to influence employee behaviour and enhance employee motivation. As many organisations are beginning to realise, competitive difference may ultimately be made by non-financial factors. As Gratton (2004) notes:

> *'… while motivation is determined by both monetary and non-monetary factors, money has come to play an overly important role in our thinking about the causes of behaviour. In most companies, very limited time and effort are spent on considering non-monetary sources of motivation.'*
>
> Gratton, 2004

Before we go on to discuss these non-financial sources in more detail, it will be helpful to clarify some of the concepts involved and to take a brief look at the theoretical background behind the topic of motivation that underpins the issue of non-financial recognition.

2.1.1 Theoretical background

It is easy to get confused when discussing the concepts of reward and recognition because of the large overlap that exists between them. Dictionary definitions of reward typically centre around the idea of something given in return for good done; recompense, remuneration, or compensation for services. In line with this, performing certain behaviours becomes a means by which to obtain the reward, so the reward acts as an incentive. In this way, an employee does something *in order to* obtain the reward.

In contrast however, the concept of recognition concerns special notice or acknowledgement of something done. A common example of recognition may be an individual receiving a reward for bravery. So, although recognition may encourage and support certain behaviours, it does not have the same '*in order to*' relationship as reward. As Hansen *et al.* (2002) note:

> *'We would never think of promising a cash bonus for every act of courage under fire. In fact, the thought of remuneration for such deeds actually cheapens them. On the other hand, try to get a teenager to clean his room without some clear contract about what is in it for him.'*
>
> Hansen *et al.*, 2002

The central tenet of the distinction is that rewards are promised from the outset, whereas recognition is afforded in a *post hoc* manner. This difference is crucial because reward and recognition can impact employee motivation in different ways. As Hansen *et al.* (2002) report, many organisations fail to make an adequate distinction between recognition and reward. The consequence is that organisations often make the false assumption that all that is needed to enhance employee engagement and motivation is to find the right incentive. However, the problem with this line of thinking is that recognition and reward represent two distinct mechanisms of human motivation:

'It plays out across the corporate landscape everyday: organisations attempt to motivate employees but disregard the essential nature of human motivation. Businesses implement motivation programs that are not only ineffective but end up sabotaging the very goals they are trying to achieve.'

Hansen *et al.*, 2002

The great early motivational thinkers such as Maslow (1954), Herzberg (1966) and Deci (1975), despite differences in their approach, generally described two distinct motivational subsystems: i*ntrinsic* and *extrinsic* motivation. Intrinsic motivation can be thought of as internal thoughts or feelings that feed one's desire to achieve, perform or become involved in activities. Intrinsically motivated behaviours are those which are motivated by the underlying need for competence and self-esteem which may be performed in the absence of any apparent external stimulus. In contrast, extrinsic motivation is that which stems from the work environment external to the task, it is usually stimulated by external rewards.

Whereas financial reward clearly influences extrinsic motivation, it has little impact on intrinsic motivation. Recognition is needed to enhance intrinsic motivation. As Pfeffer (1998) notes, emphasising pay as the primary reward encourages people to join and remain with organisations for the wrong reasons, meaning that intrinsic motivation is undermined. Organisations' emphasis on financial rewards neglect and ignore other, non-financial, aspects of motivation:

'People do work for money – but they work even more for meaning in their lives… Companies that ignore this fact are essentially bribing their employees and will pay the price in a lack of loyalty and commitment.'

Pfeffer, 1998

One of the reasons for this is the 'extrinsic—incentive bias' in many organisations. Chip Heath at Stanford University reports that managers are generally poor at judging what motivates people. They tend to think that people are more motivated by money than they are. Survey evidence in the USA suggests that pay ranks third in importance in the minds of employees behind factors that relate to job satisfaction (Morse, 2003). This mirrors TUC surveys in the UK that equally found that money was not the prime issue for people.

This is not to deny that financial incentives are not important: they are, but in the right circumstances. Money provides a goal in itself and offers a sense of status and recognition (if, of course, it is sufficient!). It gives satisfaction to recipients. The problem is that these effects can be very short term in nature. If used to affect behaviour or action, temporary compliance can be induced, but not a permanent shift in behaviours and attitudes, and certainly not greater organisational affiliation. And financial incentives can work too well: driving actions without sufficient regard for the consequences. Priorities get distorted and non-incentivised tasks get neglected. (See, for example, Kohn, 1993, for a critique of performance-related pay.)

By comparison, recognition schemes can reach the parts that financial incentives cannot. They can hit such buttons as 'feeling valued and involved', give a sense of job satisfaction and encourage co-operative behaviour. These, and other, aspects of intrinsic motivation, are what tend to drive employee engagement (Robinson *et al.* 2004) and this in turn drives better organisational performance. For the public sector especially, where simplistic target-driven performance-related pay schemes might not be appropriate, attention should be given to non-remuneration aspects of work (*eg* job autonomy, development opportunities and flexible working patterns). Non-financial recognition has its part to play in this context, (Reilly, 2003).

2.2 What is non-financial recognition?

2.2.1 Defining the concept

Non-financial recognition is a method of identifying either individual employees or teams for particular praise or acknowledgement. The size, scope and formality of non-financial recognition schemes vary tremendously. In terms of a definition, non-financial recognition can be thought of as:

> *'… a non-cash award given in recognition of a high level of accomplishment or performance such as customer care or support to colleagues, which is not dependent on achievement of a pre-determined target.'*
>
> Rose, 1998

The most significant part of this definition concerns the term '*non-cash*.' It is important to be aware that the concept of non-financial recognition does not necessarily mean that the recognition provided should have no financial value, it simply means that whatever is given, it should not be just money. Money is certainly valued, however as discussed earlier, its impact on intrinsic motivation is limited at best. A report by IDS (2002) contends that it is the act of recognition itself and the esteem it gives to employees that is the heart of the motivation provided by non-financial recognition. Moreover, this method of conveying appreciation is also likely to be considerably more memorable than a cash award which is simply subsumed into an employee's salary. Instead, in non-financial recognition schemes, the organisation can offer a gift, an experience or the means to purchase material goods of their own choice.

Employees' expectations are much higher these days and they want to do things as well as have things. In this way, non-financial recognition schemes provide employees with something tangible that they can remember: a special day out or a great meal can instil much more positive effect than a sum of money paid into a bank account, net of tax and national insurance. Even the cliched carriage clock may be a source of pride and link the employee even more to the employer. Organisations can also offer a degree of choice for their employees if the scheme allows their participation in the selection of the recognition item.

2.2.2 What different forms does it take?

There are a wide variety of ways in which non-financial recognition can work in practice. Schemes range from those that are informal and impromptu to more formal structured schemes. For example, in its most basic form, non-financial recognition may be concerned with acknowledging the efforts of employees by:

- the manager saying thank you
- the manager writing formally to record thanks
- a more senior manager in the organisation writing to the individual
- public appreciation of the effort in a team meeting, in an organisational newsletter or at a special dinner

- a public gesture acknowledging contribution under difficult circumstances
- declaring the individual 'employee of the month or year'.

In other words, there is a hierarchy: recognition becomes more formal and public commensurate with the perceived value of the action. Some organisations would use all these steps, or just a few of them.

Alternatively, the employee may be given the chance to enjoy a 'present' of some kind away from the office or factory. This can be achieved by providing:

- retail or travel vouchers
- use of recreational facilities
- meals for the individual and partner
- theatre or cinema tickets
- reserved car parking space
- rewards based on points, accumulated 'air-miles' style
- provision of 'red letter days' — a special experience, *eg* an outdoor activity (hot air balloon flight) or pampering (a day in a beauty salon)
- domestic goods, *etc.*

Distinction in the way an action or behaviour is recognised is illustrated in Table 2.1. This shows that some forms are public and formal, whereas others are informal and private.

Types of recognition are many and various. According to research conducted by IDS (1999), there is no standard approach

Table 2.1: Dimensions of Recognition

	Public	Private
Formal	Award presentation: 'employee of the year'.	Letter from manager Significant gift
Informal	Acknowledgement at team meeting	Thank you Small gift

Source: IES 2004

to non-financial recognition. Schemes vary with the size and sector of the employer, and the objectives of the approach (*eg* what behaviours are to be encouraged). However, the IDS report argues that the most influential factor determining the nature of the scheme is organisational culture. This dictates which form of recognition will be most appropriate to the organisation concerned. In reviewing the evidence, the following methods appear to be the most widely used in non-financial recognition schemes. These will be discussed in turn:

- praise
- vouchers
- nomination-based schemes.

Praise

At the most fundamental level, non-financial recognition can be as simple as personal acknowledgement by managers to employees that they have performed well. Perhaps the most obvious benefit of this approach is that a simple, informal '*thank you*' doesn't cost anything. However, good management practice suggests that this should occur anyway, regardless of any scheme.

> The Inland Revenue's 'Valuing Contribution 'approach emphasises the manager's role in giving encouragement to individuals and teams. It, for example, gives managers tips on their role in recognition:
>
> - Saying 'thank-you'
> - Acknowledging those employees giving their personal best
> - Recognising small successes as well as big
> - Ensuring recognition is timely, specific and fairly distributed
> - Taking an interest in your colleagues as individuals
> - Sharing information with colleagues
> - Asking for ideas and input.

Vouchers

An increasing number of organisations are finding voucher schemes to be highly effective and popular with employees.

Voucher schemes are particularly liked because they give employees a certain element of choice. Moreover, unlike a cash award, vouchers cannot be absorbed into the employee's salary and quickly forgotten. Vouchers can also be seen as a double reward, that is, one reward when they receive the voucher, and another when they spend it.

In actually selecting a voucher scheme, there are several issues for organisations to consider. It is all too easy for organisations to simply opt for the voucher which provides the most competitive discount without really considering the wishes of employee who will receive it. Organisations should aim to suit individual taste and provide enough choice to do this. In addition, the organisation must take account of the utility of the voucher, *eg* the time frame employees have to use their vouchers and employees' ability to spend it (for example, whether there is a branch/store in the local vicinity). As People Management and Personnel Today explain:

> *'Others [organisations] think they have chosen the best scheme for their employees, but, in fact, are choosing what the marketing or HR director would like to receive, not what is most welcome to the staff.'*
>
> People Management, 2004

Voucher schemes are 'great if staff are shop-a-holics with a relevant retail outlet nearby, but difficult if they are shop-a-phobics having to visit an inconvenient location to find the item they want' (Jonathan Haskell, LongService.com, Personnel Today, 2003).

It is sensible therefore for organisations to involve employees in the design of the scheme. This can be done through employee surveys and focus groups to ascertain employee preferences.

Attention also needs to be paid to the internal promotion and marketing of the scheme. There are various vouchers available on the market. Some of these are specific to a particular store and these offer the advantage of associating the organisation and its employees with aspirational brands that are held in high regard. Alternatively, the are some vouchers on the market which are much more flexible. For instance, some voucher companies offer vouchers that can be redeemed in over 50 different high street stores.

Nomination-based schemes

Organisations that do not wish to offer something that has a monetary value can offer a memento, trophy or certificate to denote the employee's contribution. This may be based on nomination by colleagues. 'Staff achievement awards', as they are sometimes called, allow employees to nominate one of their colleagues in a number of award categories. The latter will reflect the types of behaviours/actions that are seen as worthy of recognition. This could be teamworking, customer service, individual contribution, *etc*. The winner typically receives some sort of prize, which is commonly presented by a senior figure in the organisation, either in private or at a special award ceremony (discussed in more detail later).

Methods for nominating employees range from completing a basic ballot card to presenting detailed information and supporting evidence via web-based forms. Although it seems the most common arrangement is nominations by work colleagues, in some organisations, nominations may be received from the individual him/herself, customers, service users, or clients.

In organisations with multiple sites across the country or with a large number of employees, a more complex, tiered scheme may be used. Tiered schemes are typically structured so that the first tier represents the employee of the month in each region/ location; from these winners, the second tier represents the employee of the year from each of the individual regions/ location; and the third tier represents the overall employee of the year from the regional finalists.

Recognition can also be for teams as well as for individuals with the same, or similar, process and award categories. For example, the London Borough of Brent has the following award categories:

- service improvement
- supporting colleagues
- delivering the corporate strategy
- leadership and motivation
- personal achievement
- delivering services to a diverse community.

The following awards will be open to team/service units:

- improvement in performance
- consistently high achievement
- achievement in adversity
- delivering the corporate strategy
- delivering services to a diverse community.

One of the most debated questions for award schemes is whether they should be presented publicly or privately. The answer will depend upon the extent to which the organisation wishes to celebrate the achievement of employees as opposed to just simply acknowledging their contribution. Where the focus is on celebration, it is likely that an annual formal ceremony will be held at which the awards will be presented. Again there is choice over whether the award should be a surprise for the individual or whether the winner is informed in advance. An organisation should decide this in the light of the views of its employees.

> Orange's recognition scheme illustrates a number of the above features. It introduced a scheme in 1999 whereby staff are encouraged to fill out 'thanks' cards to acknowledge the contribution of colleagues. The emphasis is on going beyond the expectations of the job. A monthly draw for the nominees is held in the presence of senior managers with the winner receiving £500 worth of money or vouchers. Ten others receive smaller amounts.
>
> At Virgin Trains, the emphasis is on customer service. Both staff and customers can nominate for 'great service awards'. Scheme winners are judged by peers not managers. As with Orange, there is draw to determine winners who receive low-value retail vouchers.
>
> Both schemes have higher level awards for exceptional service/ contribution (IDS, 2002).

2.2.3 Which behaviours should be recognised?

The behaviours or actions which are reflected in the recognition scheme criteria should be based on those behaviours or actions that the organisation wishes to emphasise. This could be the demonstrating organisational values or offering a role model for other employees. Empirical research by Rose (1998) suggests that non-financial recognition schemes usually fall into four categories:

1. delivering excellent customer service
2. actions above and beyond the call of duty
3. generating ideas for performance improvements and innovation
4. exceptional contributions and teamwork

This is supported by evidence produced by Thomson and Milsome (2001) who note that it is common for the criteria in non-financial recognition schemes to centre around outstanding customer service or dedication to the job.

What this suggests is that there is a distinction in recognition schemes between those that acknowledge inputs (ideas or effort) and those that reflect outputs (service delivery or successful contribution). In somewhat similar vein there are schemes that emphasise pro-social behaviours (teamwork, communication, *etc.*) and those that concentrate on business benefits, whether internal, like performance improvement or external such as customer satisfaction; see Table 2.2).

Table 2.2: Categorisation of criteria

	Input	**Output**
Pro-social	Co-operative behaviours	
Business	Improvement ideas	Customer satisfaction

Source: IES 2004

2.2.4 Prevalence

Various surveys have gauged the prevalence of non-financial recognition schemes in the UK over recent years. Rose (1998) contends 75 per cent of organisations surveyed had in place some form of non-financial recognition scheme. The survey also illustrated that such schemes were much more common in industries that rely on high levels of customer contact. In contrast, organisations based in the property, engineering and construction sectors seldom implemented non-financial recognition schemes. Another study by Brown and Armstrong (1999) estimated that 50 per cent of UK organisations use non-financial recognition schemes. This survey found such schemes to be particularly prevalent in knowledge and technology-based sectors, as well as sales and service functions. Bevan (2003) suggests that in excess of 60 per cent of UK employers use non-financial recognition.

2.3 Organisational benefits

In considering the different rationales organisations have for implementing non-financial recognition schemes, Rose (1998) surveyed 81 large UK organisations. He was then able to establish four principal reasons why organisations typically implement such schemes. These were to:

1. acknowledge performance above and beyond the norm
2. enhance customer service
3. recognise achievement
4. support line managers.

Similar studies conducted in the US (WorldatWork, 2002) suggest that organisations hope to achieve a number of goals through their recognition schemes. These objectives and the frequency with which they were mentioned are displayed in Table 2.3.

2.3.1 Encouraging strategic behaviours

Perhaps one of the most obvious benefits of non-financial recognition schemes is that they afford an organisation the opportunity to highlight desired actions and behaviours. In so doing, creating role models for other employees. The thinking behind this is that by recognising outstanding achievement and

Table 2.3: Main objectives of recognition schemes

Objective	Percentage
Create a positive work environment	84
Reinforce desired behaviours	76
Motivate high performance	73
Increase morale	69
Support organisational mission/values	68
Increase retention/decrease turnover	51
Encourage loyalty	45
Support a culture change	23
Other	9

Source: WorldatWork (2002)

certain behaviours, other employees will aim to imitate such ways of performing. Also, the whole process of recognition can be used explicitly as a method of contributing to the achievement of organisational objectives. The organisation can signal the values/behaviours it wishes to promote and employees can be recognised when they respond.

Sending such signals can help pull the organisation together through common messages, thereby steering behaviours across the whole organisation. The intended outcome is to create a '*unity of purpose*' between employees to and the aspirations of the organisation, and between disparate parts of an organisation (if there is a need to emphasise corporacy). Indeed, Brown and Armstrong (1999) reported that organisations were overhauling their non-financial recognition schemes so that there is a much clearer focus on strategic business goals and values such as team work, customer service and business improvement.

Hansen and Hansen (2002) argue that non-financial recognition schemes are 'appropriate to intrinsically motivated behaviours such as inventiveness, commitment and initiative'. They say this because 'the application of recognition will have a different set of outcomes from the application of reward.' In other words, to get employees to hit sales targets, an extrinsic motivator like a bonus would be appropriate, but, to encourage innovation, you need mechanisms that tap into job satisfaction and creativity — intrinsic features of motivation.

Bhavna Mistry makes the same point more elegantly:

> *'Most of the commentators… are echoing Maslow, Mayo, McGregor, Hertzberg — the behavioural gurus who concluded that if you offer the right individual, the right thing at the right time, you can effect behavioural and even attitudinal change'.*
>
> Human Resources, 2000

2.3.2 Cost-efficiency

Research conducted by Industrial Relations Services (1999) suggests that non-financial recognition schemes can help fulfil organisational objectives at a relatively low cost:

> *'One of the key attractions of recognition-based schemes are their cost-efficiency. The most obvious benefit is that awards made*

under recognition schemes need not be expensive, as it is their symbolic value and not their cost which is important.'

IRS, 1999

A report by Incomes Data Services (1999) makes the same point. The awards given under the banner of non-financial recognition are typically only worth between £25 to £150. But, as the monetary value of the award is less important than the act of recognition itself, these sort of schemes offer good monetary value. Since their symbolic value (as a visible sign that individual contribution is being acknowledged) is greater than their monetary worth, organisations get a better 'bang for their buck'.

2.3.3 Immediacy of impact

Another benefit of non-financial recognition schemes is the immediacy of their application. Traditional performance appraisal and reward is typically done on an annual basis. However, all too often any payment is distant from the performance it is rewarding. Remoteness can result from the fact that the bonus/pay increase is based on an average of a year's performance.

More relevantly to non-financial recognition, specific actions that merit a reward may not be properly taken into account. In contrast, some non-financial recognition schemes can have a greater immediate impact by permitting near immediate responses to desirable actions. This clearly reinforces the desired behaviours on a more regular basis.

2.3.4 Employer branding

The increasing prevalence of employer branding and employer marketing has been another stimulus for the increasing interest in non-financial recognition schemes. The thinking behind employer branding is that if an organisation has an external brand to attract and retain customers, then why not do the same internally so that that both existing and potential employees can identify with the brand. Non-financial recognition links with the concept of total reward here, as organisations can use the whole range of benefits, both financial and non-financial, to make a statement about the organisation and its culture. This can be employed to promote a more positive organisational image.

2.3.5 Retention

In the introduction, we pointed to the over-reliance of organisations on financial rewards. There is little doubt that focusing solely on financial rewards creates *instrumental* relationships: 'I work for you just because you pay me'. It is easier for competitors to lure away your staff — they just have to pay them more money. In terms of retaining key talent, building *affective* relationships between employer and employee binds the two more closely together. This in any case makes the individual less likely to leave and makes it harder for rival organisations to compete. Non-financial recognition schemes can help reinforce affective relationships. And they are more difficult for other organisations to match compared extrinsic forms of reward.

2.3.6 High street credibility

Non-financial recognition schemes are generally highly regarded in terms of their ability to enhance motivation and job satisfaction among employees. Several research studies (*eg* Brown and Armstrong, 1999) report that non-financial recognition schemes have a very high rate of assessed effectiveness compared to other types of performance rewards. Not only that, but they can also play a pivotal role in total reward packages by way of contributing to the whole employee experience at work.

Non-financial recognition schemes can offer a more in-depth and longer lasting impact on motivation than more transient financial rewards. Recent empirical research tends to bear this out. A survey of 372 managers by McCartney and Holbeche (2003) found that non-financial recognition was the fourth most popular motivator (mentioned by 65 per cent of managers) after job enjoyment, personal drive and challenge. By comparison, financial reward was found to be a weaker motivator — cited by just 31 per cent of respondents. Interestingly, the research also found that the biggest single demotivator at work was a lack of recognition (mentioned by 54 per cent). This was ahead of poor management (53 per cent), bureaucracy (46 per cent) and lack of time to achieve the set workload (43 per cent).

Likewise, a large-scale survey by the recruitment company Reed, reported in Personnel Today (2000), found that employees reported increased job satisfaction when they felt their organisations appreciated the hard work they put in. The study also found that financial rewards were rated by employees as only the sixth most important factor in achieving job satisfaction. In contrast, recognition was found to be the most important factor.

Non-financial recognition **schemes** can encourage managers to acknowledge a job well done at the time it was done. They can help reinforce messages that managers may have received in people management training on motivational techniques. The benefits to staff should be obvious:

> *'People need to know not only how well they have achieved their objectives or done their work, but also that their achievements are appreciated.'*
>
> Armstrong, 1999

2.4 Problems and potential pitfalls

2.4.1 Value of the scheme

The way the non-financial recognition scheme is set up has a significant effect on its future success. In particular this relates to its scope. As the IDS (2002) report contends, the more inclusive the scheme the greater the likelihood is that it will be perceived by employees as being fair. This means that all employees in whatever their role would have the opportunity to be nominated for an award. Felt fairness has to be a key characteristic of non-financial recognition techniques because it appeals to the emotional, affective side of people. By contrast limiting the scope to those in high-profile or customer-service oriented roles, for example, will edge a scheme closer to a more instrumental approach seeking extrinsic motivational responses.

In considering the development of a non-financial recognition scheme, organisations also need to decide on the number of awards to be offered. The danger of having a large number of awards is that scheme is devalued. This may decrease its credibility among employees. In contrast, if the number of awards is too low, the scheme could potentially demotivate employees if they feel as though they do not have a realistic chance of winning.

In addition to questions of scope, in constructing a non-financial recognition scheme, attention has to be given to the value of the award. By definition, the financial value will be low, but this makes it even more important that the award is attractive. We have already emphasised that the best way to achieve getting awards that are valued is through employee participation in the choice of awards on offer. Nelson (2004) recommends that employees are asked for their views (via surveys or focus group) regarding what they would value. Employees certainly expect their schemes to be up to date with the latest fashions, technological innovations and designer names. Schemes that only offer limited or out-dated options risk being viewed as uninspiring.

Some schemes fail because they offer what the organisation thinks is valuable, not what the recipient does. In particular, there is a tendency to emphasise organisational symbols rather than something of use to employees. Have you got a company crested paperweight, or three?

In summary, the scheme design has to offer attainable prizes that are worth having.

2.4.2 Credible assessment process

Another aspect of fairness is procedural. It is important to ensure that whichever method of recognition is used, the process by which receivers of vouchers, certificates or awards are chosen should be credible, transparent and robust. If employees feel in anyway that the assessment method has not been fair, the scheme may be undermined. This is in turn will render the approach not just worthless, but potentially damaging if it demotivates rather than motivates staff.

2.4.3 Managerial skills

Recognition schemes can be handicapped by managers. This may be because their lack of skills is revealed in inconsistent operation of the scheme, or, worse, bias towards certain individuals or against particular groups. It may be seen in poor judgement or lack of knowledge of staff. For example, giving a box of golf balls to the non-golfer or chocolates to a slimmer. Delivery of a simple thank you may be wooden or deemed to be insincere.

These skill deficiencies may result from a selection system that favours technical skills or achievement of results over people-centred, softer skills. The organisational culture may emphasise extrinsic motivators. As American consultant Andrew Lebby (managing partner of the Performance Group) put it: 'Just as it is easier for some parents to show love with gifts rather than hugs, it is often easier for organisations and managers to show gratitude with money than with words'. This reflects the limited value placed on people management skills in many organisations.

So, however good the scheme design, poor implementation may render it worthless.

2.4.4 Cultural fit

As the two points above illustrate, it is better for employees to use non-financial recognition approaches to align with the culture of the organisation than to challenge it. Incentive schemes may be deliberately counter-cultural (and many performance-related pay schemes are designed to work in this way), but for non-financial recognition to be successful it has to seem appropriate to the mores of the organisation.

This also means that the type of prizes have to be seen as fitting the particular work environment. Some more conservative workplaces may reject American style 'gizmos' or 'razzmatazz'; other companies love the hype and going *OTT*.

2.4.5 Tax and small print

Another potential pitfall when implementing non-financial recognition is that some schemes can be damaged by not thinking through the implications. This can happen in two ways. First, the government classes vouchers and other non-financial awards as taxable benefits. Therefore, it is important for organisations to ensure that the value of their award to the individual is not reduced through subsequent taxation. It is essential that organisations cover the tax and National Insurance contributions required. Second, if the scheme is structured in such a way that it costs employees time or money to take advantage of their award, for example, if they need to travel a long distance to redeem their vouchers, the award may lose its appeal.

2.4.6 Fraudulent nominations

Many non-financial recognition schemes, especially those which involve nominations, are dependent on the honesty of employees and their managers. There is always a chance that some employees may conspire to fraudulently win awards. It is sensible for organisations to have some process in place by which nominations are substantiated. Many schemes therefore check the validity of nominations before they are given to the judges to be considered for an award. One way of doing this is to have the nomination authorised and signed by line managers before being passed to the judging panel.

2.4.7 Maintaining momentum

There is a real need for organisations to review their non-financial recognition schemes regularly, and update them where appropriate to ensure that they are still effective. The risk is that employees lose interest. The IDS (2002) report suggests that:

> *'In general, successful employee recognition schemes should be thought of as ongoing projects. There are always new and innovative ways to be found for streamlining processes and maintaining employees' interests. Recognition schemes have a limited shelf-life'.*
>
> IDS, 2002

In relation to this, Tahmincioglu (2004) argues that recognition schemes that centre around nomination-based awards are not particularly effective over the longer-term, although they may feel good at the time. She suggests that it is all too easy for non-financial recognition schemes to become a '*whose-turn-is-it-next*' scheme. To counter this potential risk, the scheme design needs to be periodically refreshed.

2.4.8 Economic situation

Tahmincioglu (2004) also contends that the external economic environment can impact on the effectiveness of non-financial recognition schemes. For example, in a time of downsizing and restructuring, non-financial recognition may not be effective in motivating employees. When a situation like this arises, such schemes can appear to employees to be empty attempts to appease employees and could potentially backfire.

2.5 Solutions

In order to deal with the above problems, the following guidance may be helpful:

- Aim for inclusivity in your schemes. This will encourage participation and minimise resentment.
- Give attention to process and design. For example, get the criteria right. Procedural justice, the process of how the individual is treated, is more in important in felt fairness than distributive justice, the outcome of the reward (Tyler and Bies, 1999)
- However, try to avoid producing detailed procedures because it may mean managers operating by rote.
- Instead, work on the skills of line managers and, if possible, encourage the selection of those with high levels of interpersonal skills.
- General guidance on non-financial recognition should then be sufficient.
- Involve employees in the design of any formal scheme. As Charles Fay (cited in Morse, 2003) found in his research, process has to fit objectives and objectives have to resonate with the workforce.
- Go with the grain of the organisation culturally. Performance-related pay schemes might legitimately challenge the status quo, but, to be effective, non-financial recognition has to be done in a way that is acceptable to employees. (See the parallel with team pay in the NHS — Reilly *et al.*, 2004.)
- But, you can still make non-financial recognition schemes fun, as the AXA PPP scheme below illustrates.
- Base-pay levels have to be sufficient for non-financial recognition to operate successfully. Employees will not so easily accept gifts or gizmos if they think this is a substitute for a decent wage.

- Connect your approach to recognition with other aspects of reward. Total reward can be a powerful branding signal and a significant aspect of the psychological contract.
- Periodically refresh any scheme, as they easily go stale.

AXA PPP healthcare introduced a recognition scheme with a 'banana drop'. This was to publicise that whoever was rated the person who made the greatest difference would be designated the 'top banana'. S/he would be given a day off, a recognition card and a present. There is a parallel scheme for team awards. Strangely, they are not called the 'top bunch'!

2.6 Conclusion

In line with the ethos of total reward, organisations increasingly need to consider reward more broadly. Those whose reward strategies are able to strike a balance between extrinsic and intrinsic reward will be in a much better position to reinforce the psychological contract they have with their employees, and make the whole experience more positive for all those involved. Where organisations are able to gain a thorough understanding of their employees' expectations in return for their hard work, organisations are able to determine how their reward strategies can help to deliver what is really needed.

However, having said this, organisations have to be careful not to fall into the trap of recognising employees by simply giving them 'stuff' on an occasional basis. For the majority of employees, it is how they are dealt with by their managers on a daily basis that is the most important factor. Moreover, treating employees right everyday effectively communicates that they are trusted, respected and that they are important. Indeed, it is ironic that many non-financial recognition schemes are often simply concerned with attempting to remind managers that there are things that they should be doing anyway as good management practice, regardless of any scheme.

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3. How Flexible is your Reward?

Michael Silverman and Peter Reilly

Over the last decade, as the external environment has become more turbulent, organisations have sought initiatives to ensure the recruitment and retention of a high quality workforce. Faced with this problem, many organisations have attempted to remedy it by simply offering increased pay. However, whilst this may provide some respite in the form of a short-term solution, this approach may not be delivering the best results. Instead, some organisations have turned to wider approaches to reward. Total reward, as we shall see, does this embracing a whole range of mechanisms that aim to attract, retain and motivate staff.

Flexible benefits offer a narrower means of offering choice to employees, but can allow a degree of tailoring the reward to fit their needs. This latter point is especially important as the workforce becomes more diverse in nature. What might be attractive to a married, middle-aged, white male is unlikely to be the same as someone younger, of different ethnic origin and marital status. This is especially so as there is greater and greater interest in work-life balance issues. Again, childcare help may be central for some groups, elder care for others or concierge services for a different population.

So, total reward and flexible benefits are in the limelight because organisations have rightly calculated that having a better understanding of what turns their employees on will bring benefits in recruitment and retention. Making employees a priority for the future is more likely to offer competitive advantage.

This chapter will, firstly, outline the nature of total reward and flexible benefits. It will then describe how common such schemes are in the UK. Next, it will set out the reasons for introducing these remuneration initiatives. Common problems and obstacles will then be reviewed before looking at some practical questions. The concluding section will address some broader issues and the implications for reward management.

3.1 Total reward

The concept of total reward is based on the assumption that people work for more than money. As Schuster and Zingheim (2001) report, it is rare to find an organisation within the FTSE 100 that pays its employees more than less well performing organisations. Instead, high performing organisations offer, what they refer to as a '*better workforce deal*':

> *'In the better workforce deal the organisation and the employees meet halfway. The organisation invests in people and the people meet it by learning new skills and competencies and performing to reach organisational goals. It is a positive deal, where both are winners.'*

While money is obviously an important part of reward, it is increasingly evident that it takes more than just cash to recruit and retain high quality employees. There is debate about how specific one should be about the content of total reward. The CIPD and practitioners tend to see total reward as a practical matter. E-reward, by contrast, talks about a philosophy, a set of principles, a 'mindset' rather than a set of particular reward practices (IDS, 2003). Schuster and Zingheim (2001), in rather similar vein, suggest that the concept of total reward comprises four components:

1. **Compelling future**: Employees want to be able to draw self-esteem and satisfaction from working for a particular organisation. They want to feel that the organisation has a positive vision of the future and a set of values that they can support.
2. **Individual growth**: Employees want to have opportunities for training and development and the chance to apply this. Organisations need to provide meaningful training that will prepare employees to fill the roles that the organisation requires. Consequently, this implies a need for appraisal and feedback.
3. **Positive workplace**: Employees want to work in a pleasant environment. Roles and workplaces should be designed around

employees, with a focus on facilitating their development. Employees need to feel that what they do is important and to understand how their role relates to the organisation's goals. This requires open communication.

4. **Total Pay**: Total pay comprises basic pay, performance-related pay, benefits, and recognition or feedback. Employees want total pay that is designed around their role and their needs. Some of the options available are basic pay to reward the employee's continuing value; performance-related pay to emphasise results; benefits to provide protection from life and health hazards, in addition to holidays, recognition and feedback. Of all the elements that comprise total pay, recognition and benefits are best positioned to address individual need and preference. Flexible benefits offer individual choice and help with the flexibility required by a diverse workforce.

An organisation's total reward strategy describes the basic principles and scope for designing rewards across the organisation. As Brown and Armstrong (2001) state:

> *'It [total reward] concentrates overall on developing reward management as a strategic, innovative and integrative process, designed to meet the evolving needs of organisations and the people they employ.'*

Schuster and Zingheim (1998) contend that senior management needs to give consideration to the following six reward principles as they develop their total reward strategy.

Create a positive and natural reward experience. Senior management needs to be aware at the start of the process, of the importance of communicating and educating employees on how rewards are changing, and the advantages to the workforce and the organisation. Employees need to be involved in the whole process.

Align rewards with business goals to create a win-win partnership. There needs to be a win-win situation for both the organisation and employees. As employees contribute to the organisation in achieving its goals, those same employees need to share in its success. To encourage this win-win situation, senior management needs to ensure that employees have a clear direction and that they feel valued by receiving appropriate rewards.

Extend employees' line of sight. Engage employees in understanding how what they do affects and influences bottom-line results.

Integrate rewards. Be aware that different reward tools have very different outcomes and use each reward tool for what it does best. Take an overall perspective not only of money but also of total reward.

Reward employees' ongoing value with basic pay. Use basic pay to reward the skills and competencies needed by the organisation, the employee's consistent performance over time, and the employee's value relative to the labour market.

Reward results with performance-related pay. By rewarding employees based on results, performance-related pay creates stakeholdership and a win-win relationship between the organisation and its employees.

The principles and the components of total reward are important in aligning reward with organisational strategy. The better the fit between the approach to total reward and the business strategy, the more likely that the reward scheme will be effective. To recap, as Brown and Armstrong (2001) summarise, a total reward approach combines several disparate factors:

- **Financial rewards;** such as basic pay, variable pay, share ownership schemes and employee benefits.
- **Non-financial rewards;** for example, recognition, development opportunities, the work environment and work-life balance.

In this way, the term '*reward*' itself actually takes on a meaning which is greater in scope and which is not an alternative word for '*pay*,' '*remuneration*' or '*compensation*' (Watson, 2002).

As mentioned previously, organisations that are able to address individual need and preference in terms of total reward are more likely to attract and retain key employees. This is certainly the thinking behind the likes of PwC, the Nationwide Building Society and Norwich Union, that have been quoted as being proponents of total reward (IDS, 2003). Norwich Union, for example, describes three components of their total reward approach — 'performance', 'development' and 'a career framework'. Through these means, the company hopes to give greater attention to non-financial aspects of reward (IDS, 2003). This then can become part of the employer 'brand' to be used in recruitment.

Variable pay and non-financial recognition are covered in other chapters of this report. Benefits are dealt with below, whilst employee financial participation is the subject of a previous IES report (Reilly, *et al.* 2001) listed in the references.

3.2 Flexible benefits

3.2.1 Issues and definitions

A reward policy that has become increasingly popular in the UK is to provide employees with flexible benefits, that is, giving employees scope to make their own decisions about how their remuneration package is comprised. Flexible benefits, also referred to as '*cafeteria benefits*' or '*flex*,' typically allow employees to choose from a menu of optional benefits to suit their specific preferences and lifestyle requirements. A useful definition provided by Stredwick and Ellis (1998) is that:

> *'It is a formalised system that permits individual employees to influence the make-up of their pay and benefits package, so that they may select certain items and reject others to match their personal requirements.'*

As opposed to giving employees a salary and fixed additional benefits that can either be taken or left, the basic concept is that an employee is given a package value and is able to select their benefits within pre-defined limits.

> *'Too often, companies will offer their staff benefits that they do not want or value as highly as others. Employers need to find out what their employees want, and tailor the benefits they offer accordingly. Employees cannot be treated as one homogeneous group, and good employers are increasingly going to want to fit benefits around the requirements of each of their individual employees.'*
>
> Aldred, 2001

AstraZeneca define flexible benefits as:
'... the means by which individual employees can tailor their individual salary and benefits package to meet their individual needs within an agreed compensation cost.'

According to some commentators, there are two different types of flexible benefit schemes that organisations can offer (Lewis, 2002). The first of these is referred to as '*true flexible benefits*,' which include goods and services that are paid for by the organisation. The second type are known as '*voluntary benefits*,' in which employees are presented with a variety of discounted goods or services for which they pay themselves, for example, holiday discounts and cheap CDs. This approach is often criticised for being a kind of half-way house for those organisations that are not yet ready to move to true flexible benefits, or even further, for being at the '*grotty end of the flex market*' (Lewis, 2002). Voluntary benefit schemes do not really offer flexibility at all, but they may sit alongside flexible benefit schemes as an additional offering.

Flexible benefit schemes should ideally cover a comprehensive range of benefits. These might include work-life benefits, especially various forms of leave or work breaks; convenience benefits, such as concierge services or shopping vouchers; lifestyle benefits like gym membership; status related benefits, particularly company cars and more traditional protective benefits including, insurance and pension contributions. How one classifies the offer of free fruit is not obvious!

For the vast majority of organisations, employees are forced to preserve certain core benefits. These typically include minimum pension provision, life assurance, personal accident insurance, permanent health insurance and 20 days' holiday. These basic benefits continue to apply to all employees to ensure that no employee reduces their benefits to below a safe level. As Hay's Simon Barron puts it: 'most companies won't flex pensions or life insurance — as they don't want to have to explain things to the grieving widow' (Tulip, 2003).

Beyond these core benefits, employees are free to flex. A popular option is for organisations to provide flexibility in terms of holiday, allowing employees to exchange annual leave for other benefits within the scheme. In the minimalist versions, this might only entail a salary 'sacrifice' of accepting a lower pay for more holiday, or vice versa.

Another area that has become increasingly prominent is employee share ownership or profit-driven bonuses, though not necessarily as part of a flexible benefits' scheme.

> *'The linking of elements of employee remuneration to their company's financial performance, through profit-related pay and share schemes, is gradually becoming more widespread and is increasing to the extent that people are now sharing their employer's risk.'*
>
> Hay Group, 2000

Research by Hay Group (2000) reports that 53 per cent of the 136 UK organisations surveyed in its annual survey of employee benefits offered some kind of long-term incentive scheme. The UK government is introducing a highly tax-efficient 'All Employee Share Ownership Plan' to encourage employees to hold shares in the organisation. This is providing a great opportunity for organisations to overhaul existing reward strategies in order to promote and improve employee engagement. Although it also has to be said that companies' interest in profit sharing and share ownership schemes has tended to wax and wane with the tax regime in place at the time (Reilly *et al.,* 2001).

3.2.2 Flexible benefits and total reward

With reference to the four components of total reward suggested by Schuster and Zingheim (2001), the notion of flexible benefits falls mostly within the total pay component. In relation to this, many organisations typically think of reward only in terms of tangible benefits, such as those which comprise flexible benefit schemes. By comparison, the concept of total reward is much more comprehensive, it considers reward both in terms of tangible benefits and those which are much less evident.

For example, Albertson (2000) argues that although most large organisations have always offered training to employees (at considerable expense), the broad area of learning and development has not traditionally been considered a reward. However, with organisations requiring a steady supply of new skills and employees wanting to ensure continuing employability, viewing development as a reward is becoming more important. In a related vein, Abbott (2003) cites findings from Watson Wyatt's 2002-03 *Top Performing Employees Survey* that shows that employees consistently ranked career opportunities and work-life balance initiatives far ahead of tangible benefits.

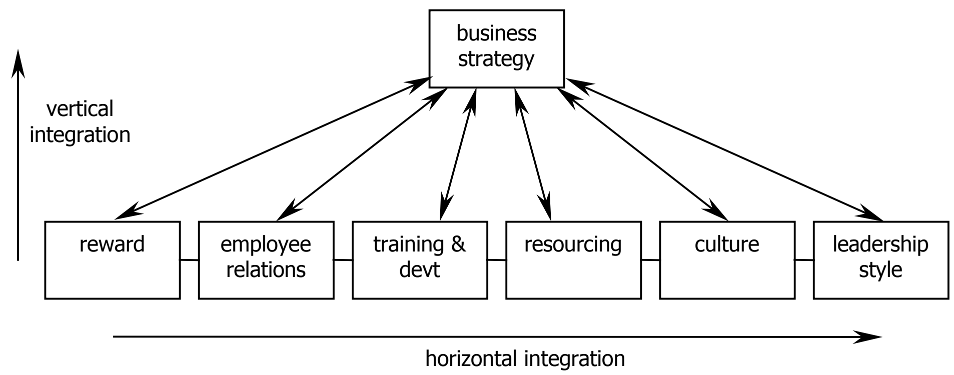
Some would argue that the notion of total reward is also centrally concerned with the relationship between an organisation's reward strategy and its business objectives. In an empirical investigation by Towers Perrin (2000a), managers were asked to rate the strength of association between various benefits and organisational strategy. Overall, it was found that there were strong relationships for learning and development/career opportunities (mentioned by 38 per cent of the managers), followed by leadership development (33 per cent), recognition (31 per cent), and work-life balance initiatives (16 per cent).

In contrast, strong relationships between organisational strategy and healthcare benefits were mentioned by 60 per cent of managers, as was the relationship for savings plans, also 60 per cent. This suggests that currently many managers do not realise the importance of alignment. Albertson (2000) agrees, arguing that many organisations pay lip service to the notion of alignment. Only a handful take the necessary steps to ensure that their reward strategy is linked to organisational goals:

> *'Implementing a rewards strategy without considering its impact on the business may prove to be counterproductive and a waste of resources.'*
>
> Albertson, 2000

Alignment not only has to be vertical in linking to the business strategy, it also has to be horizontal in connecting to other aspects of the HR strategy (Figure 3.1). In other words, the approach to remuneration has to be consistent with the approach to training and development, to resourcing, to employee

Figure 3.1: People management integration



Source: IES 2005

relations, *etc.* The total reward concept sets out to make these links, especially to development, because its aim is to take a holistic view of employee recognition and motivation.

Flexible benefits may relate to recruitment and retention objectives, yet in reality they may be positioned within the organisation as simply another pay device trying to get a 'bigger bang for one's buck'. There may not be any broader attempt at greater employee engagement or participation.

Lynda Gratton (2003) has recently reminded us that there is a *third dimension* to alignment: implementation. It is all very well aligning HR policies with the business strategy or having an internally coherent programme of people management, but theory has to be translated into practice. If the delivery is good, the policy will be effective. However sophisticated the initiative, if it is not properly implemented, it will fail.

3.3 Prevalence of flexible benefits

3.3.1 Total reward

There is no research on the take-up of the total reward concept. Given that total reward is a reasonably new concept and that UK organisations have only recently begun to explore the idea, this is not surprising. One suspects that the concept of total reward is still a long way off in practice for most organisations. They may address the different components that make up total reward, but not integrate them in an effective and systematic way. In particular, learning and development are not necessarily seen as a reward and valued as such (not least because of the difficulties of quantifying the benefits), especially as these will vary from individual to individual.

It appears, therefore, that for the time being, a total reward approach remains on the periphery of mainstream reward practice in the UK (Brown and Armstrong, 2001). Nevertheless, progress is being made and a core of practical experience is developing.

3.3.2 Flexible benefits

Previous research into the extent of the use of flexible benefits tended to suggest that it was more talked about than done.

Administrative complexity was always seen to be an obstacle to implementation. This was partly because of the cost of delivering choice to employees, but partly because of the time taken up by HR staff in managing the activity. Nowadays, technological innovation has facilitated flexible benefit schemes. A number of consultants now offer various packages that ease the process and which make good use of IT.

Computer technology is now capable of handling the complex decision-making processes involved in flexible benefits and at a reasonable cost (Johnson, 1996). A more competitive market place has also led to more cost effective products and services being offered by suppliers. This makes outsourcing cheaper, as well as in-house provision.

HR staff may be involved in scheme design, but the operation may be in the hands of employees themselves. The application of flexible benefits has been a key feature of employee self service. In addition, there are a number of outsource providers that are keen to remove the burden of both design and operation from HR departments.

Various surveys have been conducted to elicit the rate of uptake of flexible benefits by organisations. A summary of the most recent findings is given below. Although there is a variation in the figures presented here, there is a general consensus regarding two aspects. Firstly, organisations now have a heightened awareness of flexible benefits. Secondly, although the desire for such schemes continues to be high, the likelihood of the floodgates opening remains low. It appears that there will be a slow, but continuous, increase in the number of organisations implementing flexible benefit schemes in the immediate future. As Thompson and Milsome put it in their 2001 review of reward practice:

> *'Flex is still somewhat at the margins of mainstream benefit practice, although take-up appears to be gathering pace. But despite the hype, flexible benefits remain far from universal.'*

Lewis (2002) argues that between five and ten per cent of organisations currently have formal schemes in place. However, the research suggests that between 50 and 60 per cent of UK organisations are actively looking at introducing flexible benefits over the next few years.

IRS Employment Review's annual *Pay Prospects Survey* (2002) indicates that for the past two years, flexible benefits had topped the agenda for organisations considering changes to their reward systems. The survey reports that 24 per cent of organisations stated that they have either already introduced, or are considering introducing, flexible benefits over the next 12 months.

The *Employee Benefits Research Supplement* (2002) reports, in a survey of 282 UK organisations, that just nine per cent have adopted a flexible benefits scheme.

As reported by HR Zone (2003), the tenth annual Flexible Benefits Survey found that 2002 saw the largest increase in organisations implementing flexible benefits for the previous decade. The research reveals that 70 per cent of responding organisations had already implemented a plan, or were considering doing so. Take-up of flexible benefits is almost certainly biased towards the private sector and then towards financial services. Companies in this environment are more likely to offer a range of benefits that can be flexed.

In the public sector, there are likely to be fewer benefits (*eg* private medical insurance is not available on principle in government departments) and ones of a more fixed nature (*eg* the defined benefit pension scheme). Moreover, the technological infrastructure that facilitates employee choice may be missing in a large number of organisations.

There is also the question of how many of the flexible benefit schemes are truly that. In 2001 it was estimated, for example, that there were only 200 'fully fledged' schemes in operation in the UK (Thompson and Milsome, 2001).

3.4 Drivers of flexible benefits

Organisations give many and varied reasons for introducing flexible benefits. The principal reasons are as follows:

- recruitment and retention needs
- legislative and social pressures
- cost-cutting requirements
- organisational alignment

- response to mergers and acquisitions
- pay harmonisation
- generating employee understanding.

3.4.1 Recruitment and retention needs

Without question, the primary reason most organisations give for implementing flexible benefits concerns recruitment and retention. A survey by Hewitt Associates (2001) revealed that over one-third of organisations believe that flexible benefits play an important role in recruiting and retaining employees. Indeed, Higginbottom (2001) cites a survey of 300 organisations conducted by the recruitment agency Office Angels that demonstrated that over 50 per cent of employees would prefer flexible benefits to a pay rise or promotion. There is evidence that giving employees the chance to tailor their own package improves retention and facilitates a better understanding of the cash value of the benefits they receive.

For example, How (1998) reports that a pre-flexible benefits employee survey found that only 53 per cent of employees were satisfied with their fixed benefit package. But in the first year after flexible benefits had been introduced, employee satisfaction increased to over 70 per cent.

> *'For many organisations the decision to implement flexible benefits has led to lower recruitment costs, improved employee satisfaction and increased retention.'*
>
> How, 1998

Osborn-Jones (2001) concludes that the traditional psychological contract has been replaced by a complex mix of values, attitudes to employment and benefits. Offering more money to employees no longer ensures success in attracting the right people because just offering more money is too easily matched (or even bettered) by competing organisations. Keating (2003) suggests that flexible benefits have the capacity to act as an effective retention tool, especially in the early years where many organisations experience high employee turnover. The rationale is that if employees are able to access benefits that suit their lifestyle, they may be less prone to leave. Keating argues that reward strategies have evolved so that the philosophy of choice must be underpinned by a scheme that looks at how existing benefits can be made flexible. In this way, organisations will be able to market and offer an effective retention tool for their employees. As reported by HR Zone (2003), the tenth annual Flexible Benefits Survey conducted by Hewitt, Bacon and Woodrow, found that over 60 per cent of the 400 organisations surveyed reported that the introduction of flexible benefits increased employee commitment and retention.

Moreover, the needs and aspirations of younger employees are impacting on the recruitment and retention strategies of many organisations (Kent, 2001). The number of 16 to 25 year-olds in the UK has dropped significantly over the past 25 years. Organisations are facing increasing competition in recruitment and need to find new ways of recruiting and retaining key employees. Flexible benefits are one of the options they can use. For example, graduates may perceive an employer without flexible benefits as second rate.

Certainly, How (1998) argues that the increase in flexible benefit usage may simply be a result of companies offering flexible benefits to remain at the cutting edge of recruitment practice. The main problem with this line of thinking though is that if you only have a flexible benefits scheme because everybody else has one, the only competitive advantage the organisation can gain for the considerable cost of implementation, is that they are not disadvantaged by not having one. That is, no advantages are to be gained, just disadvantages to be avoided.

In 1997, the Royal Bank of Scotland set out to improve its reward system in a bid to strengthen its employer brand, and attract and retain key staff. In October 1998, it launched RBSelect, a flexible benefits scheme giving employees a wide choice of benefits and a great deal of flexibility in how they allocate the overall value of their package (Blackman, 1999).

Legislative and social pressures

There is a large overlap between flexible benefits and family-friendly policies, for example, child-care vouchers, workplace nurseries, or buying and selling holiday entitlement. Currently, there is a certain amount of legislative pressure being applied to organisations to provide better work-life balance options for employees. This is likely to grow. The current Labour government is increasingly talking of the 'personalisation' of state services. 'Choice' is the buzzword of the moment: allowing people to fit services to their own specific needs. This is in the context of encouraging more mothers to return work, assisting the economically inactive to back into employment and allowing more variation in retirement patterns.

Flexible benefits can allow employees to react to changing family circumstances, be they marriage, divorce, childbirth, moving house, *etc.* With a more diverse workforce and greater social change, the concept of flexible benefits aligns well with the current social environment.

However, Willmott (2003) argues that organisations are not buying into the family-friendly attitude espoused by the current government. In a detailed survey of over 1,000 organisations and advisers, it was found that most organisations offer the bare minimum of work-life balance policies, and the majority do not expect that their employees will want to take up their full statutory rights. Moreover, Willmott highlights the fact that many organisations are inadequately prepared to deal with the immediate impact of the changes in maternity, paternity and flexible working rules that have been introduced in recent years.

Cost cutting

Savings for employers

Many organisations perceive a strong financial incentive for implementing flexible benefits. Schuster and Zingheim (1992) thought that one of the principal drivers for a *new reward* strategy on employee benefits (which they called 'indirect pay') was to cut costs. They acknowledged that this might sit alongside what could be a contrary driver of meeting employee needs in order to attract and retain staff (as covered above) and alongside the requirement to gain greater alignment between organisational goals and reward goals (dealt with below). They spoke of benefit flexibility as offering 'not only patterning choices to match employee preferences, but also containing indirect pay costs' (1992).

Although offering flexible benefits is no longer as tax-efficient a strategy as it once was, it still provides an opportunity to make some savings (*eg* a salary sacrifice to increase holidays reduces employer National Insurance charges) and to review costs. By providing an allowance per employee, organisations are in a better position to predict and control their benefit costs. Moving to flexible benefits may provide the opportunity to shift from a defined benefit plan (a potentially open-ended financial commitment) to a defined contribution plan. Defined benefit plans usually cost the organisation about 18 per cent of an employee's salary, as opposed to a defined contribution plan that typically costs ten per cent. Whilst Additional Voluntary Contributions (AVCs) allow enhancements to defined benefit plans, in a flexible benefits scheme more choice can be provided in the funding of a defined contribution arrangement.

Similarly, Das (2002) notes how flexible benefits can also save money by capping costs. Typically, the cost of benefits can fluctuate, so organisations do not have control over costs. With flexible benefits, however, organisations can establish benefits as a percentage of salary. The cost of benefits may fluctuate, but the risk of cost rises pass to employees.

Paul Farrell of Aon even argues that payroll numbers could be reduced if employees elect to take more holiday (though this might presumably increase workforce numbers). He is convinced that the cost reduction argument is key to getting management attention. 'Soft, cultural issues' are all very well, 'but what turns heads is money'. He believes 'there is a whole range of areas where you can calculate genuine cost savings' (Tulip, 2003).

Savings for employees

Organisations can also use their corporate buying power to cut costs for employees. They can secure discounted rates for items covered within a benefits scheme. So, for example, employees may benefit by choosing gym membership at a discounted rate within the flexible benefits scheme, rather than taking the value in the form of a higher salary and then joining the same gym independently. Similar employee benefits arise when organisations are in a position to offer a not-for-profit service, such as childcare facilities or cheap loans within a flexible benefits scheme.

In addition, more subversive flexible benefits schemes can also be used to lower the paybill. For example, organisations can price particular benefits so cheaply that they are irresistible to employees, or highlight the most cost effective benefits in total reward statements to put them into the forefront of employee's minds. Over the years small changes like these can have a considerable impact.

One of the largest misconceptions organisations have about total reward is that they think it involves adding more reward elements as opposed to reorganising them in a more efficient way. Organisations need to be aware that they can strengthen their reward strategies without necessarily increasing their overall investment:

> *'It's largely a matter of reallocating resources, rather than finding more resources.'*
>
> Towers Perrin, 2000b

This may be because expensive benefits can be curtailed in exchange for greater flexibility. Thus, a flexible benefits system might allow the reduction of 'excessive' holiday entitlement or the removal of 'over-generous' pensionable allowances, as either the *quid pro quo* for the introduction of the scheme itself or in the design of the core benefits.

Organisational alignment

A move to flexible benefits is congruent with many HR strategies that are aimed to create more fluid and responsive organisations. This is the Schuster and Zingheim new pay argument (1992). If organisations are to prosper in a world of increased competition and change, reward needs to be more flexible. It should adapt to changing business circumstances. Traditional benefits packages, are regarded by Schuster and Zingheim as too fixed as entitlements and too determined by length of service. The researchers argued for benefit plans to co-ordinate with other elements of remuneration and to get employees to 'focus on the strategy and tactics of their organisation' (1992).

Flexible benefits can both enhance and emphasise the flexibility of an organisation to change. The implementation of flexible benefits demonstrates to employees that different employees within an organisation have different needs. It reinforces the sense that differentiation in reward is legitimate. This concept can then be more successfully extended to performance driven elements in reward, including in benefits provision.

Some organisations have suggested that the very fact of having to decide how to best compile their flexible benefits package promotes decision-making skills in employees. It certainly can improve their participation in organisational affairs and even engagement in its activities.

Response to mergers and acquisitions

Mergers and acquisitions also provide a significant business case for introducing flexible benefits. When two benefit environments are coming together in one organisation, flexible benefits are a good way to achieve '*benefit harmonisation*' (How, 1998). Benefits costs can be minimised by valuing the different remuneration packages and fixing values before the merger. Employees are then given the opportunity to choose their benefits within a flexible benefit scheme. This ensures that all employees are rewarded fairly.

> *'When companies merge or form partnerships there are usually differences in benefits. It can be hard to keep someone motivated when they are sitting next to someone with extra holiday entitlement. Flexible benefits can help with that integration, as well as working as a good retaining instrument.'*
>
> Kent, 2001

AstraZeneca's drive to introduce 'Advantage', its flexible benefits reward package, was the merger between Astra and Zeneca. There was a requirement to bring together ex-Astra and ex-Zeneca employment conditions. For management, this had to be done:

- quickly
- in an industry leading way
- in a way that protected 'legacy' entitlements
- with minimal cost.

Pay harmonisation

The extension of benefits may be driven by a desire to create a 'single status' situation where all employees, irrespective of grade, are remunerated on the same terms. Organisations do this to signal that everyone is 'in the same boat, pulling together in the same direction'. It may be promoted in unionised organisations to weaken trade union power or it might be aimed at increasing employee commitment to and alignment with the goals of the organisation.

In practical terms, harmonisation may be made easier through flexible benefits in the same way as in a merger. It allows different sets of terms and conditions to be combined in a cost efficient way. As indicated earlier, the flexibility element also encourages employees to see the need for adaptability in remuneration, and the element of choice reduces the collectivist dimension to remuneration and emphasises the individual.

Generating employee understanding

A clear driver for flexible benefits is to generate a better understanding in the workforce of the high value of benefits provision. Thompson and Milsome (2001) point to two surveys that illustrate the problem. In one Towers Perrin survey, employees estimated the cost of benefit provision to be less than 20 per cent of pay, when in fact it typically represents 30 to 40 per cent. In another survey done by Hogg Robinson and the Prudential, it was estimated that 4.8 million employees covered by group life assurance were unaware of this benefit. This ignorance was not untypical of the benefits on offer. As Paul Bissell says: 'Most people get more benefits than they think. The challenge for managers is to increase employees' understanding of what they are receiving' (Carrington, 2004).

To counter this situation some organisations have developed 'total reward statements'. They typically include a summary of the benefits provided, an outline of the annual costs and a graphic display of the various components of an employee's total rewards. Each total reward statement is personalised and, in a flexible benefits environment, can describe the individual choices made.

Statements can be a cost effective way of highlighting the major provisions of an organisation's reward scheme so that employees can have a better understanding and appreciation of their specific benefits and compensation provided to them. It can also communicate the significant cost to the organisation each year to provide these schemes. With benefits relating to share price, there can be an educative process in encouraging the realisation that the value of the company fluctuates in line with stock market prices.

Yorkshire Water was one of the first organisations to introduce total reward statements as part of its retention strategy. It was a move to be more open and transparent about the rewards and benefits they offer. The annual statement lists how much the employee receives in benefits and pension contributions and also details of other benefits (*People Management*, 2002). HSBC also produces total reward statements that distinguish between cash and non-cash benefits. Again transparency is the avowed driver of their production. They also detail share holdings and options. Cash and non-cash benefits are totalled separately and together and the full value is expressed as a percentage of basic salary. The share scheme elements show profit at the time of the valuation.

It would be wrong to assume that it is just lower-level employees who need to realise the total sum of their benefits. Line managers too often underestimate what is already offered to employees. This becomes apparent in recruitment and retention discussions. Managers may claim that their staff are underpaid by comparison with the competition, by focusing only on the basic salary, forgetting the importance of the benefits package.

Evidence

Table 3.1 highlights data from a large-scale survey regarding the reasons why flexible benefits are introduced. Below is a specific example of why flexible benefits were lauded in one organisation.

Centrica introduced flexible benefits to:

- establish common employment terms
- move towards a modern employment 'prospect'
- breakdown cultural barriers
- enhance staff choice and appreciation of benefits
- support the attraction and retention of high quality employees
- enhance employee satisfaction by recognising different lifestyles.

Table 3.1: Drivers of implementing flexible benefits

Driver	% of organisations
Helping retention	18.9
Meeting the diverse needs of employees	16.9
Increasing employee understanding of total reward	17.7
Helping recruitment	15.0
Containing future benefit cost increases	8.4
Harmonising total reward arrangements	7.7
Removing/reducing status symbols	2.9
Reducing the total cost of rewards	1.6

Source: Hewitt Associates (2001)

3.5 Practical issues

3.5.1 Planning and design

Strategic alignment

To implement a flexible benefits scheme, senior management must first understand what they want to achieve at a strategic level. For example, how would implementing flexible benefits influence issues such as recruitment, retention, and the organisation's ability to remain competitive? And how would it encourage certain behaviours and discourage others? Moreover, what proportion of the paybill ought to be spent on benefits as opposed to basic or variable pay. This insight should inform the decisions made about the design of the scheme.

The reach of the scheme also needs to be determined, that is, whether the scheme will apply to all employees or just specific groups of employees. The coverage of the scheme will depend upon the extent to which the organisation wants to introduce flexible benefits as a means of conveying that all employees are equally valuable, or to provide recruitment and retention incentives for key employees. The development of flexible benefits can be part of a drive to harmonise terms and conditions, or, conversely, as a means of differentiation by grade, or even possibly by performance.

Benefits on offer

This question can be viewed from two different perspectives. The organisation might decide on the basis of its strategic discussion above, what are the benefits that should be offered that will meet its business objectives in a cost effective way. The alternative angle is to decide what will meet employee needs.

The direction organisations are coming from will impact on the benefits offered. Some organisations make the full range of benefits available to all staff, particularly where there has been an attempt to harmonise terms and conditions, or where the scheme is being promoted as demonstrating a shared interest in the organisation. However, some benefits may be reserved for higher-graded staff (*eg* company cars) either for status or cost-control reasons. The business need is the stronger driver.

It seems, at least recently, that most firms interested in flexible benefits have emphasised employee- rather than business-need. This is no doubt a reflection of a tight labour market and growing emphasis on the requirement to attract and retain in the 'war for talent'. It also reflects the wider driver of demonstrating that the organisation is aware of work- life balance questions.

If the latter approach is taken, conducting employee focus groups and/or surveys is a good idea in order to find out what they like about their existing scheme, and what they might like to see in a flexible benefits scheme. This establishes the range of benefits to be presented and is about being aware of what items employees think should be open to flexing.

> To find out how employees felt, the Royal Bank of Scotland commissioned Hewitt Associates to conduct focus groups with their delivery among staff in London, Edinburgh and Manchester. Employees were also asked to complete questionnaires. A critical element of the review was a series of interviews with managers, in order to gain their strategic input and to secure their backing for the scheme (Blackman, 1999).

Benefits to flex

The next key decision is which benefits will remain core and which will be flexed. Practice seems to vary a lot, not least because the initial benefits on offer vary so much.

The Work Foundation survey on flexible benefits (2000), including nearly 300 HR professionals, describes that the benefits most often offered to flex are healthcare, extra holidays and company cars. Some organisations also include life or medical insurance, share options, childcare vouchers and gym membership.

The tenth annual Flexible Benefits Survey (reported in HR Zone, 2003) found that employers are now offering a greater variety of lifestyle benefits: 71 per cent of respondents offer childcare vouchers; 50 per cent offer retail vouchers; and just under 50 per cent offer, or are considering, a computer to use at home.

Lloyds TSB's (Employee Benefits, 2002) flexible benefits scheme allows a cash allowance of four per cent of basic salary, which employees can take as cash, or spend in the flexible benefits scheme. They can also buy benefits with up to 50 per cent of their salary. Flexible benefits are divided into three categories:

- health and well-being
- leisure and lifestyle
- protecting your future.

AstraZeneca's flexible benefits plan, 'Advantage' offers:

- lifestyle options: nine choices
- health options: two choices
- financial options: three choices
- protection options: four choices.

The top ten benefits in Centrica's scheme are:

1. extending private medical insurance to partner/family
2. additional holiday
3. critical illness insurance
4. retail vouchers
5. life assurance
6. dental insurance
7. AA membership
8. AVCs

9. tax advice
10. childcare vouchers.

Table 3.2 shows data from three different surveys illustrating the most common benefits to flex.

RebusHR (2002) found that the benefits most likely to be added

Table 3.2: Most common benefits to flex (per cent)

Type of Benefit	(RebusHR)	(Employee Benefits)	(Hewitt Assoc.)
Private medical insurance	90	—	80.3
Holidays	83	28	75.3
Season-ticket loan	—	68	—
Life assurance	83	—	—
Pension scheme	75	—	—
Health screening	63	—	59.2
Dental insurance	63	56	74.0
Critical illness insurance	63	—	59.1
Permanent health insurance	63	48	—
Home insurance	—	56	—
Company cars	60	40	70.3
Pensions (AVCs)	60	32	—
Personal accident insurance	58	—	—
Childcare vouchers/allowance	55	24	—
Leisure club membership	50	24	—
Travel insurance	45	—	—
Dependant's pension on death in service	45	28	—
Financial counselling	40	44	—
Share options	—	40	—
Training allowance	30	—	—
Retail vouchers	28	32	—
Private car leasing	25	—	—
Health cash benefits	20	—	—
Legal expenses insurance	10	—	—

Source: RebusHR (2002); Employee Benefits (2002); Hewitt Associates (2001).

to existing schemes in the future are:

- retail vouchers
- childcare vouchers
- financial advice
- healthcare benefits
- legal expenses
- personal insurance and travel insurance.

In this study, administrative workload did not appear to be a serious consideration in terms of which benefits were offered, and there was no relationship between the difficulty in administering particular benefits and their popularity. Hewitt Bacon Woodrow, from its 2003 survey, claims that home computer purchase is up and coming, along with voucher schemes and travel insurance (Tulip, 2003).

3.5.2 Establishing the cost

Even if the organisation has taken the conscious decision to align benefit provision with employees' wishes, there is still an imperative to control costs. The issue of how much to spend per employee is critical in deciding what should be included in the flex scheme. Estimating what the take-up of the benefits will be is another aspect in the cost equation that needs to be considered. How (1998) illustrates the importance of thinking about costs up front:

> *'Clearly performing a detailed cost analysis is crucial — and may yield surprising results. One organisation eventually decided against including holidays on its flex scheme, when it discovered that such a move would expose it to a £3m additional cost. Many of the firm's employees, who had fallen into the habit of not taking their full holiday entitlement, had not been claiming payment in lieu.'*

3.5.3 Pricing benefits and estimating take-up

A crucial aspect of implementing flexible benefits is giving each benefit a value, *ie* setting the price tags. A key question organisations need to consider is whether they want to price the benefits neutrally or price them slightly higher to cover the costs of administration until the scheme gets on its feet. Or put another way, should the organisation or the employee pay for the cost of implementation?

As mentioned previously, organisations can also price particular benefits in such a way that they will be more or less attractive to employees. This can be an effective tool in helping to estimate the take-up of the various benefits. In relation to this, How (1998) notes how it difficult to know, before the scheme is implemented, what the take-up and hence cost of various benefits will be. Although focus groups or surveys can help, financial estimates might rely on guesswork in estimating how many employees will take which options:

> *'The problem arises when giving people choice where choices can influence the absolute cost.'*
>
> How, 1998

Another approach is to pilot a new flexible benefit scheme in a particular business unit or location before rolling the scheme out to the rest of the organisation.

Centrica piloted their flex scheme in their former credit card Goldfish business. This had the advantage that it was a new company where employees did not have the baggage of historical terms and conditions of employment. Moreover, the workforce was young and enthusiastic for flexible benefits.

O'Farrell (2000) suggests that the most effective way of designing and pricing benefits is to take into account two factors: Firstly, demographic data that shows the relationship between population characteristics and typical employee choices; and secondly, data concerning previous patterns of choice for employees or a similar group. Looking at the demographics of the employees within an organisation can help to forecast which benefits may be more popular. For example, younger employees with few commitments may choose to get rid of dependants' benefits and take more pay or holidays. Whereas, employees with families are more likely to choose childcare benefits or better medical insurance.

Taking into account the various factors concerning pricing and take-up, statistical modelling techniques can be conducted to see the financial impact of a range of pricing options and take-up rates. These exercises may not be simple, as there are certain psychological considerations to bear in mind when designing options and pricing benefits:

> *'Experience shows that over-pricing options in relation to their true actuarial value promotes unnecessary use. Employees who are being over-charged take the view that "I've paid for it and, by George, I'm going to use it".'*
>
> O'Farrell, 2000

AstraZeneca found that phasing the introduction of their flexible benefit scheme helped with the integration of the process, allowed understanding of it to develop and gave time to 'build the brand'. Moreover, given that it is critical to have clean data on your HR information system, phasing gives you the opportunity to get this right.

3.5.4 Monitoring and evaluation

One of the most important parts of the implementation process is reviewing the scheme to see if it has had the desired effect. This can be done at a number of levels:

- Has the scheme met its strategic objectives?
  - Has recruitment and retention improved?
  - Has it changed employee behaviour?
  - Is there evidence of incentivisation?
- Has the scheme stayed within budget?
- Which benefits have been popular and which have not?
- What degree of flexing has there been?

A newly implemented scheme should be given time to settle as it may take a while for the advantages about a particular benefit to spread across the organisation. Many employees will sit back and watch their colleagues test out particular choices before they opt for those choices themselves. So this evaluation might need to wait for a year of operation before being undertaken.

Meanwhile, organisations should monitor the extent of take-up and the benefit items that seem popular. Analysis should look at differences by grade, gender, ethnicity and occupational group. This will help identify where the scheme is hitting the mark, and where it is missing its target. Of course, the cost of the scheme needs to be carefully monitored and a check made on whether design assumptions are borne out.

3.6 Common problems and obstacles

3.6.1 Issues surrounding implementation

Contractual arrangements

When considering flexible benefits, it is critical for organisations to read the small print of policies and clarify exactly what a benefit entitles their employees to receive. The reason for this is that many organisations cannot rely on individual employees to do this for themselves. If things go wrong, a poor benefit can reflect very badly on the organisation. In addition, as employees should have the permission to review and change their choices annually, it is very important that contracts run on an annual basis.

Communication to employees

Poor communication is the principal reason why so many new benefits schemes run into trouble. Many organisations do not communicate enough, if any, benefits information to employees. As we described earlier, many employees never have a realistic idea of the true value of their benefits and who is footing the bill. Hence the interest in total reward statements.

Employees also need to understand the basic mechanics of the benefits plan and how it operates. Although many employees are generally enthusiastic about being able to flex their benefits, some employees may show a significant amount of resistance.

The means of communication will depend on the specific situation of each employee. Many shopfloor workers, for example, do not have intranet access if the organisation is concentrating on an intranet campaign. Various other options exist: posters, mailing information with pay-slips, individual briefings and seminars. Organisations must also consider providing access to independent financial advisors or helplines to provide more detailed advice for employees.

The Royal Bank of Scotland's RBSelect requires much thought on the employees' part in making their selection. Employees were sent a 35-

page booklet to help them with their calculations. They also produced a video explaining the scheme, while the internal television network provided briefings and bulletins. (Blackman, 1999).

Valuation of benefits

Total reward statements seem straightforward enough, but practitioners still have difficult decisions to make. Is the value of the benefit stated in terms of the advantage it offers the employee or the cost to the organisation of providing the benefit. Usually, the former is chosen because the latter is a lower figure (partly because organisations can bulk purchase benefits). However, employees may put a different valuation on a benefit depending upon their personal circumstances. This might be age-related (pensions loom larger in importance the closer retirement comes), be affected by the benefits enjoyed by a spouse (this might produce a duplication of benefits) or for example by the state of individual health (making insurance or sick pay provision a priority for some employees and not others). In summary, employees or their representatives may dispute the corporate valuation, negating the objective of gaining greater acceptance of the worth of benefits and, in extreme cases, affecting the legitimacy of the way benefits are flexed.

Cultural dynamics

It is important to bear in mind the cultural dynamics that can result from moving to flexible benefits. For example, if an organisation decides to make holidays flexible, allowing people to swap annual leave for pay, they must consider that sickness absence rates may go up.

Another implication is that choosing flexible benefits will divert employee attention from their day-to-day work. There is evidence from the USA that this can occur: staff spend too much time looking at their benefits package on the corporate intranet. This problem is less likely to occur in the UK, largely because of the different benefit arrangements. Also, if options can only be made on an annual basis, this will limit employee interest in playing with their benefit plans.

More positively, organisations have found that they can engage employee families in the employment deal through flexible benefits. This naturally occurs because the choices that had to be made have a family impact (*eg* more leave versus healthcare insurance), and employers can encourage this process. Some do this by sending benefit statements to home addresses or by putting details on the Internet so that they can be read at home.

Specific problematic benefits

There are some benefits that are much more difficult to get right. This may be in design or in execution. In the RebusHR study (2002), it emerged that benefits that cause the most problems were:

- company cars
- holidays
- gym membership
- training and development allowances
- childcare vouchers
- pension schemes
- financial advice
- retail vouchers.

Without further information, it is not easy to know what the difficulties might be. Speculating, company cars are notoriously difficult to manage, as are pension schemes. For the rest, it is hard to know whether it is getting the right provider, determining the degree of flex, or administrative issues that are providing the problems. Interestingly, the least problematic benefits to manage were considered to be: personal accident insurance, private car leasing, health cash benefits and dental insurance. What will be true is the problems will vary from organisation to organisation dependent upon their geography, employee group and demographics. This will make some issues harder in some organisations than in others.

3.6.2 Fears of administrative burden

One of the most common drawbacks given is the administrative burden, or the fear of an administrative burden. Implementation can be an elaborate procedure, especially at the start of the scheme. Employee Benefits Research Supplement (2002) illustrates the results of a survey in which the perceived barriers to introducing flexible benefits were assessed. The results reveal that the vast majority of organisations (71 per cent) say they would be concerned about the readiness of their current administration systems, while 76 per cent were worried about the complexity of administration. However, for organisations that had implemented flexible benefits, 64 per cent said it was straightforward or simple, while only one organisation found it extremely difficult. Thirty-two per cent said it was quite difficult. The interesting point to note is that the Employee Benefits survey of two years before came up with almost the same proportion of organisations expressing identical concerns, and that the authors again made the point that 'these problems were more imagined than real' (Employee Benefits, 2000). This raises the question of whether it is purely misconception of the difficulties on the part of those organisations that have not introduced flexible benefits, or that the problems are real enough, which is precisely why they have not proceeded. The principal obstacle may the quality of the technological infrastructure. With a decent system, administrative concerns may indeed be groundless. Without a decent system, the concerns are probably justified.

The cost of implementation can also be high, and many organisations are reluctant to introduce a scheme that has no immediate bottom-line benefits. Indeed in a survey of nearly 300 HR and personnel professionals, the Work Foundation report on flexible benefits (2000), found that more than 50 per cent of respondents felt that flexible benefits schemes were costly to administer, and some said they were difficult to manage.

3.6.3 Trade union concerns

Ball (2003) notes that although unions usually welcome a reward scheme that addresses employees' needs, problems mainly arise in situations where the organisation wants to sign up to a new deal that better fits its business strategy, that is, where employees may gain some benefits, but possibly lose others. This clearly happens when part of the business strategy is to reduce, or contain costs. It might also be the consequence of trying to harmonise terms and conditions.

In addition, asking employees to be more flexible about working hours can be a particularly sensitive area, because some employees are unwilling or unable to accept higher tangible reward where it is offered as a substitute. Typically, employees lower down the organisational hierarchy are the ones who can least afford to buy services that put extra time into their life. Many need their basic pay just to cover bills. Childcare and retail vouchers are good examples where flexible benefits can still leverage the package of employees in this group. In some cases it may not make sense for the lower paid to join flexible benefits schemes, although voluntary benefits may be better suited to employees such as these.

3.6.4 How much choice are employees really offered?

In Hewitt Associates' survey (2001), 92 per cent of organisations that offered flexible benefits thought that it gave enough choice. Asked the question *'What's in it for the employee?'* many organisations would give a very positive response. Indeed, much research suggests that flexible benefit schemes are highly regarded by employees and have a number or real advantages (Stredwick and Ellis, 1998):

- Younger employees with few commitments can choose benefits to suit their lifestyles. For example, to enhance their car, get rid of some of their dependant benefits or take more pay or holidays.
- Employees with families can choose childcare benefits and better medical insurance.
- Older employees can choose higher pension contributions and get rid of dependant benefits.
- Employees whose spouses are already covered for medical insurance will not choose this item.
- Allowing such a choice in the matter demonstrates that the employer has a thoughtful and flexible approach.
- When personal circumstances change, employees can change their benefits.
- There are certain tax-efficiency advantages, particularly in the area of company cars.

However, despite these positive benefits, there can sometimes be a perception among employees that when it comes to flexible benefits, organisations are giving with one hand and taking away with the other. Or despite the emphasis on flexibility, the reality is that there is limited choice in what people can opt for. This is either because the scheme design constrains or because many benefits are too important to flex. Moreover, employees may be cynical as to the true reasons why organisations are moving to flexible benefits. Is it that the organisation is being truly altruistic? Does the organisation really want to be attentive to the needs and preferences of its employees, to give them, as Schuster and Zingheim coin '*a better workforce deal*'? Or is it just a cost-cutting exercise? Or a bit of both?

Some authors have noted the possibility of a backlash against flexible benefits, particularly as the employment market gets tougher. There may be an increasing desire among employees to move away from what are often perceived as fringe add-ons, to something more tangible. Employees' concerns about pensions and final salary schemes may well mean that they reject flexibility in favour of more traditional benefits and security (Paton, 2003). Moreover, the ability to offer flexible benefits is constrained to a large extent by the specific industry the organisations is located in. For example, in the construction industry, organisations typically make only a small percentage profit on each contract, and so a move to flexible benefits may not be possible. Furthermore, most construction organisations have no need to offer any more than their competitors have on offer, for the simple reason that no employees expect organisations in the industry to be offering it anyway (2003). As we stated earlier, for the low paid, base pay will always be most critical.

RebusHR (2002) report the results of an independent survey with 500 senior HR managers. Reasons why organisations were hesitant about introducing flexible benefits were given:

- current benefits were considered favourable
- inappropriate organisational culture
- expensive implementation and administration costs
- it had never been given consideration.

With regard to the perceived obstacles:

- 43 per cent of respondents reported the fear of an additional administrative burden.
- 37 per cent reported concern regarding communicating the scheme to employees.
- 28 per cent reported difficulties in deciding which benefits to flex and how to calculate their value.
- 28 per cent reported the need to modernise IT systems and integrate different databases.
- 23 per cent reported concerns about training employees to use the systems involved.
- 18 per cent reported the time and costs of setting up a scheme.
- 5 per cent reported concerns about measuring the perceived benefits, finding a consultant to manage the scheme.
- 9 per cent said they had not experienced, or did not expect to experience any real difficulties.

3.7 Conclusion

This chapter has reviewed what appear to be two separate concepts. They are linked in that the provision of flexible benefits is likely to be a component of total reward. The very comprehensive nature of the latter means that few organisations will have succeeded in developing approaches that fulfil their requirements. This is because many organisations struggle to develop overarching reward strategies and to integrate their HR activities. Even if there is a desire to connect career management, development, recognition and reward, there are often obstacles that impede this ambition. Organisational structures, or culture, may be a barrier to joined-up people management. The HR function may not be working well with line management partners to deliver what is required. Corporate initiatives may flounder on local, operational indifference.

Yet, though difficult to achieve, a total reward approach or philosophy has much to commend it. To achieve competitive advantage, especially in a tight labour market, companies need to offer a proposition to employees, and future employees, that resonates with the workers of today and tomorrow. The point made in this paper is that changes in the composition of the workforce and social developments mean that increasingly people want more from their work than simply money. They want job satisfaction, the chance to add skills, a balance between home and work life, *etc.* Total reward seeks to address these hopes and desires in a holistic way.

This leads to flexible benefits. Their aim is also to respond to the same diverse workforce with its varied needs. Having once been an unfulfilled aspiration for many organisations, technology now permits more sophisticated modelling and manipulation of benefits. The use of employee self service shifts the administrative burden onto staff, relieving the HR community of time consuming support. The variety of different types of employee, and the need to attract, retain and motivate them, provides an important driver to the growth of flexible benefit plans.

If the problem with total reward might be the absence of strategic and integrative thinking, the impediments to introducing flexible benefits are largely practical. Deciding which benefits to offer, costing them and estimating their take-up is essential for a well designed scheme. Getting this right so that it offers real choice to employees in a cost efficient manner is not simple. It is no surprise to see organisations using external help in designing and operating their schemes. Nor is it surprising that the most effective users of flexible benefits are those companies that can afford to offer a range of benefits or through competitive pressures feel they must offer them.

Total reward is therefore a prize worth having if the organisation is prepared to develop the necessary thinking and have the persistence to drive through the change. Flexible benefits can be a component of this move or a stand alone element. To be successful at introducing flexible benefits requires a sufficiently varied offering of benefits in the first place, and the willingness to spend time and money on design and implementation. As with many HR policies and practices, half-hearted application would be an expensive mistake.

Schuster and Zingheim (2002) are concerned that organisations have thrown too much money at trying to attract new employees through flexible benefits systems in the war for talent without evaluating the costs of so doing, and without looking at altern–ative uses of their cash. They are especially concerned that there is insufficient link between benefits provision and performance. This link is missed at individual and group level. Staff can, in their view, enjoy the advantages of extra benefits without any need for them or their organisation to perform better.

The answer to this fear is surely to make a better link between reward strategy and the business strategy. Total reward tries to offer an holistic approach to people management; flexible benefits may only be a tactical response to what turns out to be a short-term problem (attraction and retention in a tight labour market). As the labour market loosens, more HR professionals will start to agree with Schuster and Zingheim. But there are strategic reasons to develop flexible benefits. These might include the need for the organisation to emphasise adaptability and change in its people processes, as well as business processes; the need to develop adult to adult relationships between the employer and employee; to educate employees in the business realities, including the cost of their remuneration; the requirement to harmonise terms and conditions out of a merger or takeover, or out of a desire to remove grade distinctions — the commonality driver; and the wish to emphasise the diversity of employees, as much as the diversity of customers. Linking reward changes in this way to wider organisational change or imperatives is likely to avoid the risk that flexible benefits, or even total reward, is merely today's passing fancy.

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4. Facing the Market: How Best to Align Remuneration Levels

Peter Reilly and Michael Silverman

Basic pay is determined by a review of some combination of:

- an employee's specific job role
- the need to preserve an acceptable level of internal pay equity across employees within an organisation, and
- the need to provide a competitive basic salary compared to other organisations in the marketplace, industry or region (Armstrong and Murlis, 1994).

The weighting of these factors has varied according to the type of role and the sector of employment. Over time, however, there has been a general shift away from considerations of internal equity towards external equity. The particular value of a specific job role has become less about the particular skills that the employee brought to the job and more about its market price. Zingheim and Schuster (2002) complained, for example, for 'most of the history of pay' there has been a 'nearly singular emphasis on internal equity'. The future, by contrast, they think, will have a 'foundation in competitive practice so that the company and employee have a pay relationship anchored in the marketplace'.

The impetus for this rebalancing in the private sector has been the increasingly competitive business world that has spilled over into the labour market. The 'war for talent' is symbolic of this shift and, at a practical level, a recognition that companies have to work harder to attract and keep staff. The labour market has in general tightened over recent years and some jobs are especially hard to fill, be they low level or specialist.

The public sector has mimicked the private over market pay, as it has done in a number of areas of remuneration (Reilly, 2003). The Treasury has encouraged market-driven pay through the remit process and it has been a key element in the terms of reference for the pay review bodies. The push towards local pay is the most recent manifestation of this drive. In local government, more attention has been paid to the external market, both for senior appointments and for hard to fill vacancies. The fire dispute of 2003 was also, after all, an argument about the market positioning of pay. *Agenda for Change* in the NHS explicitly acknowledges that there may be location and occupational 'hotspots' that have to dealt with by pay supplements.

In the literature, the practice under discussion in this chapter is referred to as market pay, market-driven pay, market-based pay, market rating, or market pricing. Whichever terminology is used, it can be thought of as:

> *'the process of assessing rates of pay by reference to market rates – what similar organisations pay for comparable jobs'.*
>
> Armstrong, 1999

However, whilst there is a lot of talk about market-based pay from both reward practitioners and organisations themselves, there is a distinct lack of research about the scope of such a reward mechanism and the effects that has on individuals and organisations. In the case of market-based pay, research lags behind practice. This chapter tries to fill some of that void.

4.1 Prevalence of market-based pay

As organisations have responded to the increasing challenges of the external environment, it has been possible to identify certain patterns of reward policies emerging with regard to the market. For example, Towers Perrin's (1999) European Reward Survey found that there was a shift from internally focused to more market-based pay, in that the majority of respondents placed external market alignment in their top three reward objectives. The reasons given for this were that market alignment was thought to aid recruitment and retention.

M Brown (2001) also contends that organisations are now much less concerned with internal equity, and that over the last decade, concerns about the fairness of internal relativities have slipped way down organisations' hierarchies of objectives. The Towers Perrin research further reported that 73 per cent of the organisations surveyed make 'separate arrangements' for specific job roles in which the market demand is high. The separate arrangements referred to are typically market supplements which are increasingly a common feature in both public and private sectors (IDS, 2004). Other research by IDS (2003b) that has concentrated on the finance and banking sector, for example, confirms that the factor that currently has the largest influence on pay determination is an employee's position in the pay band relative to the market rate. Moreover, in the utilities sector, the use of market-based pay is common in determining pay levels (IDS, 2003b).

4.2 Establishing the value of a job

There are several perspectives from which the value of any given job role can be determined. Here, we consider three ways: it can be based on intrinsic value, internal relativities and external relativities.

4.2.1 Intrinsic value

In an absolute sense, the intrinsic value of a job is concerned with the specific job role and the required attributes of the employee:

> *'The concept of intrinsic value is based on the apparently reasonable belief that the rate for a job should be determined by reference to the amount of responsibility involved or the degree of skill or level of competence required to perform it.'*
>
> Armstrong and Murlis, 1994.

In line with this, levels of pay will be influenced by factors to do with the job itself, such as the breadth of responsibility given, the amount of resources controlled, the level of authority, the degree of autonomy they have to make decisions *etc.* Perceptions about the intrinsic value of a job are influenced by both individual and organisational outputs. That is, influence will come from the output of the individual employee themselves, and also the extent to which they are able to influence the output of the organisation as a whole. However, the difficulty with a concept such as intrinsic value is that it ignores other factors that may affect the value of any given job role. The trouble is that the value of one job will always be relative to another job. So, in reality, the value of a job is always influenced by other factors.

4.2.2 Internal relativities

From this perspective, taking an organisation as a whole, the value of a specific job is determined by the perceptions of the importance of that job role compared to other job roles. Internal relativities mirror these perceptions of importance so that the more important a job is perceived to be, the more pay that job will receive. Perceptions of internal relativities can be based on a range of information about the required inputs and outputs of a given job role. For example, with inputs, this information may relate to skills and competencies. With outputs, the information may concern the competitive edge a certain employee can give to an organisation.

Thus particular occupations have higher value in some companies than others. For example, aircraft pilots are vital to the RAF and airline companies in a way that they are not to most other organisations. Pay systems are then orientated around this key or predominant skill group. The Crown Estate, therefore, centres its pay levels around surveyors, who make up the most numerous and the most important occupation. Other occupations are then fitted in around the core group.

The inputs and outputs noted above are typically built into a job evaluation system that sets the internal relativities. In a factor-based scheme, the factors selected aim to recognise either skills and competency inputs or key job characteristics, like degree of responsibility for resources or the complexity of decision making required.

4.2.3 External relativities

In the most elementary terms, a basic salary is simply a price that represents the value of a service to the buyer and the vendor; in other words, the organisation and the employee respectively. Therefore, the laws of supply and demand might be expected to determine the external market rate for any given job. This simple economic proposition implies an analogy with other aspects of the business proposition. As an American remuneration consultant put it: 'Just as organisations compete to sell their products and services, they also compete with one another for talented employees within recruiting markets' (Fusco, 2003).

External relativities are usually assessed by reference to what similar organisations pay for comparable jobs. This can be done in a structured way via salary surveys, or in an *ad hoc* manner by seeing what competitor organisations are offering in job advertisements. Potential or actual recruits can be quizzed on the pay they have been offered elsewhere. Some organisations would test all their jobs in this way, others merely a sample.

If they do test all their jobs against the market on a frequent basis, then this substitutes for job evaluation. The market fully sets internal relativities. If a sample is used based on key jobs (see above) and/or a representative cross-section of jobs, then there is more of a combination of internal and external alignment. This is because in practice a salary survey is often a grade-based review of the market. Job evaluation sets the internal relativities that place roles in grades. The market then, in a generalised sense, puts the grade in alignment with the market.

Alternatively, market pricing can determine internal benchmarking. In this situation, the grade structure is produced by establishing the market rates for a range of benchmark jobs. Any job roles not included as benchmark jobs are then slotted into the newly formulated grade structure.

Sources of information on market pay are covered in more detail later in this chapter.

4.2.4 Internal versus external environments

In developing a reward philosophy, therefore, senior management must determine the extent to which pay within the organisation should be driven by external market forces. In other words, a reward policy needs to be established by gauging the extent to which rewards should be market driven rather than internally equitable. The assessment of both internal and external environments will provide the data needed to develop effective reward policies. If an organisation has difficulty in either recruiting or retaining particular individuals who are currently in demand within the market place, the organisation may have to relinquish its philosophy of internal equity and pay the going market rate:

> *'The pay management process must cope as best it can when the irresistible force of the market place meets the immovable object of internal equity.'*
>
> Armstrong and Murlis, 1994

When situations like this arise, there will be a degree of conflict between market rates and internal equity. Indeed, conflict such as this is hard to resolve and there may not be one solution that will provide the answer. This is why many organisations have not pushed to extremes: they have tried a middle position of responding to the market, whilst being sensitive to internal considerations.

Internal equity may also be more complicated than simply being the opposite of external. Internal equity may relate to staff wanting to be paid the same as immediate colleagues, within the same location for the same type of job, or it might be for parity with those in different business units doing analogous work. In other words, the reference point may vary with circumstances. This is important because of both equal pay considerations and matters of retention and motivation. As the government has found, civil servants may claim equity across departments not just within them, and, as manufacturing firms have found, employees at one site may look to be paid on a par with those at another.

However, the introduction to this chapter indicates that increasingly organisations have tended to emphasise the need to respond to the market, even if this is at the cost of internal equity. This re-positioning might be philosophical (organisations should be market driven) or pragmatic (if we cannot recruit and retain we are dead). It may also acknowledge that the trade unions, which have been the principal proponents of internal equity, have been weakened over the last 20 years.

4.3 The issues of occupation, sector and location

If an organisation is considering market-driven pay, what are the principal components of the market it should consider? The three that we will give attention to are those that seem to be the most important and common determinants for organisations. They are:

- occupation
- sector
- location
- grade.

4.3.1 Occupation and market-based pay

In organisations where there are strong functional groups then market-driven pay may be orientated around occupations or professions. Thus the NHS traditionally has had different pay systems for doctors, nurses, physiotherapists, *etc*. Without going as far as this, other organisations have identified key groups and treated them, to varying degrees, in a different manner from the rest. Their pay scale might be higher (not usually lower!) than comparable groups. Finally, organisations may use market allowances to supplement base pay, especially where there are recruitment and retention difficulties.

Particular interest in recent years has focused on the idea of 'job families' as a means of handling differences between occupational groups. (For further information on this topic please refer to the paper on the IES members' section of the website.) In its most basic form, job families are groupings of jobs with similar characteristics. These characteristics usually focus on common competencies, skills and knowledge, but they may relate to having a similar purpose or process. So job families often represent distinct occupational or functional groups.

Over one-fifth of organisations now operate job-family based pay structures (D Brown, 2001). They have different, market-based pay ranges and sometimes totally separate pay structures for jobs of a similar size, but in different functions or occupational groupings. The concept allows organisations to treat occupational or functional groups differently from each other in reward, career path or development need. These occupational or functional groups may or may not be linked to business unit structures. If they are, job families act as a means of vertical integration for an organisation. (For example, some organisations have a separate job family for call centres.) If they do not, job families provide horizontal integration. Support or corporate functions, like HR, finance, IT, *etc.* may be distributed across the organisation in devolved management structures. A job-family approach brings together these disparate groups. Thus this type of job family is sometimes described as 'generic' — covering similar types of work across functional boundaries. Other job families may be found only in the one business unit, division or department — such as sales and marketing or production.

Clearly the ability to differentiate the pay of one occupational group from another is central to the benefits of the job-family approach. Different occupational groups have different values in the market place and these can be reflected in internal pay rates.

Getting pay aligned with the market should assist recruitment and retention. In conventional pay systems, recruitment to the minimum of a pay range offers simplicity, transparency and protection against equal pay claims, but this method lacks the flexibility to deal with different types of applicant. These differences may well be occupationally based. Thus it may be hard to recruit a marketing person on the same salary as a production specialist. Job families allow the organisation to set entry pay at different levels to reflect these occupational market differences.

Retention should equally be improved because, through job families, the organisation is paying market rates. This reduces the chance that an employee will leave for extra money. It does not eliminate the risk. Rivals, determined to get their man or woman, may exceed normal market rates if they think that necessary. And, of course, money is only one reason (and not always the most important reason) for resignations.

There are also practical reasons for adopting job families when trying to use market rates. As Hertfordshire County Council found, trying to benchmark 1,500 jobs against the market is an impossible task (Personnel Today, 2002). Collecting information on market rates for a much smaller number of key roles within each job family is much easier to contemplate.

The Nationwide Building Society found that introducing market related job families substantially cut the number of *ad hoc* payments that had grown up over the years to deal with various remuneration problems. Removing these payments helped fund the introduction of the job-family system (IDS, 2002).

Sector and market-based pay

An alternative approach for organisations seeking to be competitive is not to see that their pay compares favourably with other employers using the same occupational groups, but to make sure that their remuneration is in line with other organisations in their same sector.

Sector seems to be important both for public and private sector employers. Research by Arrowsmith and Sisson (1999) found that the most influential factor in determining pay levels is what other organisations in the relevant sector are doing. They discovered that when one organisation adopts change, other organisations within the sector follow. They described this as the 'convoy principle':

> *'a strong sector effect is demonstrated … employers tend to move like ships in a convoy when managing change.'*
>
> Arrowsmith and Sisson, 1999

One reason why this happens is the use of sector-based salary benchmarking clubs. Take the public sector: there are pay surveys conducted for local authorities, and the Cabinet Office offers a pay database to government departments and agencies to enable them to compare their pay levels. Similar clubs exist in the private sector, *eg* in financial services. There are three particular reasons why these clubs work:

- A practical one — jobs are easy to compare because they are often so alike
- There is often, therefore, a broadly common occupational profile
- Internal valuation may be similar — *ie* if job evaluation is used, the grades are distributed in a similar way.

So on the one hand, benchmarking can be easy to do and the emerging results reliable. On the other hand, these organisations are in competition with one another for the same skills. It is for the latter recruitment and retention reason that organisations are loath to be seen to be behind their competitors. There is a certain safety in being part of the convoy. This is particularly true for those occupations that are found only within that sector. This may be because market issues concern the specific sector, not the wider labour market.

But keeping to the wartime shipping analogy, convoys are vulnerable to attack by external forces. You see this when new predators enter the market and target the weaker part of the convoy. The public sector has periodically suffered from attacks from companies seeking particular skills to be found, for example, in the civil service, be they tax accountants or economists. Substantial salary uplifts may be on offer that tempt staff away, despite satisfaction found in the intrinsic nature of the job (Audit Commission, 2002).

Another difficulty may arise for those organisations operating in a number of sectors. A sector-driven approach would suggest that consistency with a variety of external markets might be more appropriate than achieving internal harmony. However, as we remarked previously, the employees might take the opposite view.

4.3.2 Location and market-based pay

The issue of local pay in the public sector has recently received much attention from the government. In the 2003 budget, Gordon Brown raised the question of pay flexibility as a means of more cost effective departmental spending. He suggested that localised pay arrangements might have more merit than national schemes because they could be better aligned to market circumstances. The Treasury argued that the private sector is more efficient in responding to labour market signals, and if the public sector can be just as flexible it could see benefits in service delivery (through a better response to recruitment and retention hotspots) and value for money.

For the private sector, increasing market alignment might mean relating to geographical differences as much as to occupational or sectoral.

Local pay avoids having to work on the basis of a national pay system that may only imperfectly match the various labour markets within which the organisation operates. National pay systems have to average out pay rates across the country, irrespective of the recruitment or retention ease or difficulties of particular locations. This may mean that some staff are relatively overpaid for their locality, whereas others are underpaid. With local pay, resources can be steered towards the locations in which more pay is required. Not only will this aid recruitment and retention in areas in which difficulties are emerging, it also reduces the 'dead-weight' effect of increasing pay levels on a national basis when increases are only required in specific locations to match the current market rates.

Moreover, quality of staff may suffer if pay rates are too low. Vacancies may remain unfilled. Agency staff may have to be used at greater cost, and questionable quality. *Ad hoc* solutions may be found that corrupt the grading system or generate other internal inequalities. Conversely, if there is overpayment, the labour hired may be over qualified for the work and the payroll cost higher than it need be.

There are different ways in which local pay can be applied. It can be implemented on the basis of:

- separate local pay scales
- pay supplements, or
- devolving the responsibility for pay determination to line management.

Having base pay differences according to location makes sense if organisations believe that these differences are long term and structural, rather than short term and temporary. This is demonstrated by the fact that it will affect pensionable earnings, meaning that staff working in high cost/tight labour markets will benefit into their retirement.

But incorporating an allowance into base pay, or using base pay variability from the outset, is a dangerous policy if the labour market is at all volatile. It is harder to re-adjust base pay than remove a temporary allowance (though this is difficult enough). Pay differences need to be kept under regular review, otherwise pay leads may persist for much longer than is justified. This clearly is costly, but it also raises equal pay difficulties.

An alternative approach to dealing with the problem of having to operate in numerous and varied labour markets, is to set the national rate below the highest paying areas and use allowances to top up. London (and increasingly South Eastern) allowances are the most obvious example of this approach. Using supplementary allowances is an adequate response so long as they can be given and, just as importantly, removed or adjusted quickly as conditions change. Organisations usually find it easier to give allowances than take them away. As with base pay, allowances often get stuck, neither rising nor falling sufficiently as circumstances change. Again leaving allowances unjustifiably adds cost and risks claims of discrimination. Conversely, though less commonly, allowances are not extended to locations where the labour market has become tighter and the requirement for additional money is clear-cut.

Where there is devolvement of pay decisions, line managers have the flexibility to change individual salaries or offer different starting pay in response to local circumstances. Frequently, this is combined with other factors, *eg* especially performance, in adjusting individual pay levels (IRS 2001). This gives more flexibility than the other two approaches. It can be more responsive to labour market signals. It can be more specific than pay set on a pre-determined regional basis. The risk is that managerial discretion is not properly exercised. Managers may be overly generous in boosting pay rates or they may do it in a discriminatory manner.

Whatever the approach, location-based pay frequently suffers from a lack of clarity in the reasoning behind its introduction and consistency in the way that it is subsequently delivered. Is it offered to deal with recruitment or retention failings? Is it set simply because a local pay survey calculates a shortfall against the market? Or, is it determined on the basis of a cost comparison: how living costs vary between locations?

Pearson *et al.* (2004) note further difficulties in relating pay levels to local areas. Decisions need to be made on how the definition of the locality should be determined and how boundary problems can be avoided. The issue of job mobility also needs to be considered. Job mobility has been a consistent feature of much public and private sector career management and has supported the professional integrity of the system (Brown and Walsh, 1991). Whilst national pay systems allow employees to be transferred between different locations, local pay may well give rise to employees drifting to localities in which they will receive the highest pay. Furthermore, especially in unionised environments, there is the danger of wage inflation. This is because there is a risk that one location will leapfrog another, producing a constant game of catch up. Nickell (1997) argues that the evidence shows that leapfrogging (and consequent wage inflation) is a feature of 'decentralised, uncoordinated, union dominated systems'.

Then there are the problems associated with collecting and maintaining up-to-date information about market rates, though these are difficulties associated with all forms of market pay. The particular issue with respect to pay determined by location, is that organisations need to decide on what basis to divide up their workforce into pay areas. The options include:

- 'travel to work areas' (TTWAs)
- business units
- natural geography
- government boundaries.

TTWAs can precisely reflect the labour market within which the organisation operates, which involves a lot of detailed data collection. Using business units means that you reduce the internal boundary disputes, but may not reflect the labour market from which you draw staff. Geography may well affect the TTWAs, if for example transport links reflect the natural environment, but this may be coming less and less true. Government boundaries are probably rather artificial constructs in this setting. They may however have more relevance for the public sector.

Whilst it is hard to dispute that there should be a link between location and pay, in reality, as we have seen, such a relationship is difficult to achieve. Evidence from both geographical pay dispersion statistics and research on organisational behaviour, substantiates this assertion. Outside the South East, there is, in fact, only limited wage differentiation between regions (NERA, 2002). And many large organisations, particularly those in the finance and retail sectors, have common, national pay systems (IDS, 2003b). Besides offering higher pay in London and possibly the South East (through higher base pay or allowances), some large, private sector employers do have pay 'zones' that offer the possibility of some divergence from the national norm. However, these are strictly controlled from the centre. (For further inform–

ation on this topic please refer to the 'Pay and Location' paper on the IES members' area of the website.)

4.3.3 Grade

Matching the market on the basis of pay grades or points is self evidently obvious. If the organisation is trying to match the market it has to do this on the basis of comparing job hierarchies, otherwise like is not compared with like. We only refer to grade specifically to highlight that:

- grade groups may have very different labour markets from each other. This is particularly true of senior executives and graduates. This may be a matter of:
  - geography — labour markets are likely to widen with grade from local to international, illustrated in Table 4.1.
  - sector — the search for graduates or top players may be cross sectoral in a way that contrasts with positioning the rest of the organisation.
- different selection criteria may apply based on grade — *eg* more of a case of paying for potential than track record at the key entry points for new recruits.
- there may be key break points between groups in the grading system where significant changes apply to your terms and conditions (*eg* shopfloor, 'staff' and executive). A recent trend has been for organisations to reduce such variation in a drive to harmonise the employment deal.

Table 4.1: Different markets for different groups

	International	UK	Internal	Regional	Local
Main board	✓				
Senior managers	✓	✓			
Managers		✓	✓		
Staff		✓	✓	✓	✓
Works				✓	✓

Source: A manufacturing company

4.4 What drives interest in market-based pay?

For many organisations, interest in market-based pay is driven by a desire to enhance organisational flexibility and efficiency by increasing recruitment and retention, controlling costs, and increasing employee motivation.

4.4.1 Recruitment and retention

At its most elementary level, the main rationale behind implementing market-based pay is that the more competitive an organisation is in the market place with regard to reward, the better quality of employee it will attract. Similarly, by paying above the market rate, the less likely it is that quality employees will leave the organisation to take up better-paid jobs elsewhere.

In relation to this, research by IDS (2004) states that widespread recruitment difficulties in local government have led to increased differentiation in pay levels in different localities:

> *'Pay looms large as a reason for local authorities' staffing difficulties.'*
>
> IDS 2004

Similarly, organisations have principally centred on pay levels to remedy recruitment and retention difficulties. In a large-scale survey of both private and public-sector organisations, approximately 50 per cent of respondents had implemented, or were looking to implement, pay supplements. More than half of respondents reported giving pay supplements for jobs in which there were recruitment or retention difficulties (IDS, 2004). This is no doubt a reflection of the tightening of labour markets in recent years and fierce competition in some areas of the country and for particular skills.

In terms of their effectiveness, many organisations thought that market supplements had been extremely effective in easing recruitment and retention difficulties. This is despite evidence that employees do not only leave organisations because of remuneration, especially in the public sector (Audit Commission, 2000).

4.4.2 Cost control

As mentioned previously, one of the most obvious advantages of market-based pay is that money can be directed towards the locations or occupations in which more pay is required, thereby reducing the 'dead-weight' effect of increasing pay levels on a national basis, when increases are only required in specific locations/occupations to match the current market rates.

However, organisations need to be careful that their favoured means of cost control does not backfire. Some organisations have found that the job-family approach can be inflationary if line managers operate it by overrating the market value of their staff. We indicated above that there is a risk of leapfrogging in locational pay and one can see similar wage drift if internal competition develops between occupational groups or business units.

4.4.3 Organisational flexibility

Mergers and acquisitions may push organisations to market-based pay. If two companies are joined that have been internally focused in their pay arrangements, one way to consider harmonisation is to look to the external market. This would allow both parties to the merger to find a justifiable reference point that does not favour one group over another.

4.4.4 Employee motivation

It is all too easy to lose sight of the impact of market-based pay on individual employees. These is some research evidence on the importance of fairness in employees' perceptions of how they are rewarded compared to people doing similar jobs in different organisations. 'Pay referents' are those people with whom employees make pay comparisons.

Employee satisfaction with pay levels is important because it has been found to have an effect on levels of absenteeism and turnover (Cotton and Tuttle, 1986). Several empirical studies have demonstrated that pay equity is a strong predictor of pay satisfaction (*eg* Weiner, 1980). There is some dispute about whether internal or external equity has the stronger impact. The answer probably depends on the occupational group under review. However, the research reported here demonstrates the principal role that external equity plays.

A study of US academics found internal equity a little lower than external in its importance to overall satisfaction with pay (Terpstra and Honoree, 2003). Goodman (1974) also found that pay comparisons involving external referents were more strongly associated with employees' pay satisfaction than comparisons involving a number of internal referents. If we consider that decreased pay satisfaction is associated with increased absenteeism and turnover, then it follows that an employee who perceives that they are getting a 'bad deal' compared to someone performing a similar role in a different organisation is unlikely to add value to an organisation. Indeed, Blau (1994) further found that pay level satisfaction is affected by perceived discrepancies between the employee's pay and the pay of external referents.

In a recent empirical study by M Brown (2001), the impact of five different pay referents on pay satisfaction were assessed. The five pay referents assessed were:

- market
- organisational
- financial
- social
- historical.

The study demonstrated that the market referent was the most important comparator to all employees and that this referent had the greatest impact on pay level satisfaction. This finding has serious implications for organisations' reward policies. It is clear that pay equity is important to employees and that this has implications for pay level satisfaction. Moreover, as market referents have the greatest impact on pay level satisfaction, at least organisations are able to act in response. For example, market pay surveys will allow access to information about rates of pay in the market that can be then used in pay determination.

It is important to mention here that some reward practitioners (eg Demby, cited in Personnel Today, 2000) argue that the wider availability of information on earnings will lead to an escalation of pay demands. Demby contended that the growing amount of pay data available over the Internet is making it easier for employees to find out what the industry norm is for their job, such that:

> *'Mainstream professionals will soon be comparing their pay rates in the same way as footballers and company directors'.*
> Personnel Today, 2000

Equal pay questionnaires have the potential to add to this effect.

Taking this into consideration, it makes it even more important that individual rates and relativities should be adjusted in the light of changing market pressures, if the organisation is to recruit and retain quality employees. This is particularly salient with regard to employees whose market worth is high and who are therefore susceptible to the attractions of better-paid jobs elsewhere. Organisations ignore at their peril the individual market worth of any employees they wish to retain whose talent is at a premium in the marketplace.

4.5 Market-based pay in practice

4.5.1 Techniques

In order to monitor market rates, organisations can use pay surveys and various benchmarking methods to monitor their competitors, and then incorporate market adjustments into pay reviews. In Towers Perrin's European reward survey (1999), 97 per cent of organisations regarded external market pay surveys as an essential component of their reward strategy. Indeed, aided by the growth in online databases, the number of pay surveys conducted in the UK has increased dramatically.

It would also appear that job evaluation systems are now being implemented with increased flexibility. Moreover, job evaluation is becoming increasingly business aligned and market driven in two ways. Firstly, by using fewer pay bands with market-aligned ranges; and secondly, by shifting to simpler job classification approaches, such as job families. Armstrong (1999) notes that many organisations are using both of these approaches, and that hybrid designs are emerging as organisations pursue an element of both internal and external fit. For example, as Armstrong notes:

> *'The same job family definitions in some sectors are being used both as the basis for internal pay structures and external pay benchmarking. In other organisations, the points weighting for particular internal evaluation factors now relate to their correlation with market data, while some use market value as a factor in itself. So, defining a policy on market definition and stance, monitoring and maintaining that position, and reflecting labour market variations are all important components of an effective reward strategy.'*
>
> Armstrong, 1999

4.5.2 Issues to consider

Accuracy of market-rate data

Incorporating an element of market-based pay into an organisation's reward strategy can be both effective and straightforward. However, in practice, not only is it difficult to analyse job roles thoroughly, it is also difficult to conduct comprehensive market pay surveys. The main problem with a market-based pay approach is that it is reliant on how accurate market rate information is.

Demby (in *Personnel Today*, 2000) argues that the increasing quantity of market data has been accompanied by a decrease in quality of the information. Indeed, she asserts that concerns such as these may explain the fact that most internal HR practitioners do not share market data with line managers or employees. It is important to note that this remains the case despite the fact that their pay decisions may ultimately be based on it. Also, such a policy goes against what many organisations are trying to achieve in developing a transparent reward strategy that is understood and supported by employees. The issue of transparency will be discussed further later in this section.

One of the main problems regarding the accuracy of market rate information is that there is no single market rate of pay for a given job. The market only allows the assumption that people occupying equal positions tend to be paid equally:

> *'The process is circular… we know what people are worth because that's what they cost in the job market, but we also know that what people cost in the job market is just what they're worth.'*
>
> Kanter, 1989

There is a whole range of pay rates visible in the market, and organisations need to determine where to position its employees within that range. This is dependent on a number of factors, such as how it wants to be perceived in the market place, the degree of choice it wants in recruitment applicants, and whether or not it can afford to adopt the position it wants. As Gomez-Mejia and Balkin (1992) contend:

> *'While the myth persists that the market wage can be accurately and scientifically determined as a single rate, in fact there is a wide range of market pay rates available for each occupation, and the determination of the going rate for a job is a combination of art and science. Thus, the combination of decisions that determine the market wage for a firm leaves room for a great deal of subjectivity due to the many judgements that must enter into these decisions'.*

Taking this into account, it can be seen that no market pay survey can ever state the 'correct' rate of pay for a job, because in reality, it does not exist. In practice, external labour markets always offer a range of different pay rates for a given job because:

- organisations' policies differ in the amount they need to pay.
- people have their own individual market rate. This will depend on their experience, competence, lifestyle choice and the extent to which they are in demand.
- individual market worth is variable, and judgements concerning value can, and often are, more to do with perception than truth.
- the bigger an organisation is, the more it is likely to pay.
- rates of pay are higher in some local labour markets than in others.

Other issues to consider concern the fact that the accuracy of market-rate data is, in part, dependent on the extent to which similar jobs are compared with each other. Comparing jobs that have the same title does not always provide an accurate measure, because a job in one organisation is likely to have different responsibilities from the same job in a different organisation. In practice, it is very difficult to achieve an accurate and meaningful comparison.

Lastly, the data published in market-rate surveys can often be behind the times. Pay levels can change very quickly and some employees may have moved in or out since the survey was conducted.

Availability of market-rate data

Market data may be difficult to obtain in the first place. Armstrong (1999) argues that the assumption that it is always easy to get hold of comprehensive and accurate information on market rates, is ill-founded. He suggests that this is especially true for organisations that find themselves in unique or specialist domains. In organisations such as these, it is more common to develop and grow their own people internally, so when this happens, there is no standard available from which to assess the jobs, based on detailed analysis of defined criteria.

Pearson *et al.* (2004) posed the following questions in considering comparative data:

- Are there external jobs that can be used to match those in the organisation, especially where they are unique?
- How easy is it for an organisation to define its market, given that this might be different for different occupational groups?
- What market position is the organisation aiming at?
- Is it practicable to compare all the terms and conditions between organisations?

  (The concept of total reward would go beyond the terms and conditions of employment and look at issues such as job satisfaction and job security. How do you assess these and then price them?)

Though this list was compiled specifically for the public sector, it applies equally to other types of organisation. Questions such as these illustrate the complex issues involved in identifying appropriate comparators.

Pay equality

A worrying problem with market-driven pay is that attention to market rates can be discriminatory against women, in terms of equal pay. The reason for this is that if market rates for job roles that are typically occupied by women are undervalued because of a historical gender bias, then this will be mirrored in the pay structure.

Consequently, this can cause conflict between the principle of internal equity and the perceived need to be competitive. Most of the time, organisations create pay structures that strike a balance between the competing imperatives of internal equity and external competitiveness. However, these compromises may still remain discriminatory towards women.

Another common difficulty relates to managing pay relativities between job families that may in turn lead to equal pay problems. These can be of two sorts: market matching and job evaluation. Difficulties with market matching can arise if either the organisation does not do a good job of finding appropriate comparators and comparing pay rates, or because there are genuinely few comparators in the external market (a particular problem in much of the public sector).

Poor market comparisons for either reason can lead to the setting of differentiated internal pay rates, by occupation, that fail any equal pay test. In other words, differences between groups cannot be objectively justified.

Linked to this point is that it is not easy for some organisations to vary pay levels with fluctuations in the market, especially if different job families have different base pay levels. Even pay supplements introduced on a temporary basis may become institutionalised. Staff object to seeing them withdrawn; line managers are reluctant to push the point. The consequence is that the organisation is left with differential pay levels it cannot justify, leaving itself open to an equal pay claim.

With respect to job evaluation, the job-family approach may fail because it is assumed that matching jobs to the specified grade criteria is a sufficient defence against equal pay for equal value work. It is unlikely that the defence would work. The proper defence is to have and use an analytical job evaluation system that compares elements of jobs (usually) against a set of common factors. The sort of 'whole job' comparison offered by job-family methods is a poor substitute.

Risk of retention difficulties for key players

An additional quandary for organisations adopting a market-based pay approach is that because they tie key players to their organisation through the pay packet, they are more likely to leave if another organisation offers them more money. Indeed, when this situation arises, the logic of a totally market-based pay approach for free agents implodes. Duncan Brown (2001) contends that this has happened with footballers in the Premier League, he ponders:

> *'The weekly wages of Premier League footballers in England … may be taken as a demonstration of either the complete triumph, or the ultimate failure, of a totally market-driven approach to rewards. How can you ever establish a true market rate for a position, with such massive variations depending on the individual player concerned?'*
>
> Brown, 2001

Devolving responsibility for pay determination to line management

According to research, organisations are now more likely to involve line managers in reward issues as opposed to the HR function controlling reward issues (Towers Perrin, 1999). As there are now more systems for linking pay to performance, this has involved the devolvement of responsibility for pay determination from the HR function to line managers. Brown and Armstrong (1999) argue that the devolution process appears to have accelerated:

> *'It has been hailed as something of a universal process solution to the problems and paradoxes of performance related pay, the key to implementing HR and reward strategies in practice.'*
>
> Brown and Armstrong, 1999

Many practitioners, for example Hutchinson (1998), have supported this view, advocating wholesale devolution and empowerment of line managers, with the stated benefits of improved business and organisational fit; better relationships between local business needs, performance and pay; and much greater local support and ownership. Research generally supports this rationale and agenda for devolution. Indeed, Jackson (1993), in a study spanning five sectors, found that business and organisational drivers were primarily about devolving responsibility for pay determination to line management. The need to tailor systems to local needs and strengthen pay for performance linkages was found to be of secondary importance.

Questions have, however, been raised about the efficacy of devolved responsibility for reward. Lack of line management accountability and ownership was raised as a concern by 30 per cent of organisations in Towers Perrin's European reward survey (1999). Doubt about the competence and willingness of line management to actually manage pay and reward schemes regularly emerges from research and experience in organisations that have devolved these decisions. Numerous examples are given of situations where line managers have ended up costing organisations a small fortune by operating reward policies in an inflationary manner. Brown and Armstrong (1999) note:

> *'Despite the strong arguments for devolution, we often find that organisations are often reluctant to put it into practice, or at best make only a half-hearted attempt to do so. Perhaps this is because some HR specialists seem to believe that line managers are generally not to be trusted to do what is expected of them so far as their responsibilities for people are concerned.'*

This remains a contentious point. Hutchinson (1998) found little evidence of major difficulties in handing over responsibilities to line management. Others would argue that they have had the same experience. The fact that evidence supports positive and negative views suggests that managerial competence probably depends on the skills of the managers and the cultural environment within which they operate.

Transparency

As mentioned previously, one of the benefits of the job families concept is that it can offer greater transparency, especially with respect to career paths. Employees can see how they will progress in career terms and that must mean grade or band terms. This might reasonably encourage more disclosure of pay progression. In companies where the publication of pay information has not been acceptable, this poses a challenge. It may be beneficial to the family members to see how their pay grows with added responsibility and challenge in their work; the difficulty may be the read across to other families. Some organisations want staff to concentrate on their own individual pay: how does it compare against the market for them? Full disclosure of pay levels inevitably means that people will look over their shoulders to what their colleagues in other families get. Greater transparency may have benefits in terms of an equal pay defence, if that is required. It means that the organisation may have to publicly defend its pay relativities. This may be uncomfortable, but it does reinforce the need for getting good quality data in the first place.

4.6 Conclusion

Market-driven pay is here to stay. It cannot be otherwise. Organisations compete for employees in the labour market: they therefore will expect to take note of what competitors offer. However, though some commentators, especially from the USA, would want to banish thoughts of internal equity, it is not so simple. In large, complex organisations staff will want to be assured that colleagues contributing the same effort in jobs with similar responsibilities will get roughly the same money. Job evaluation offers a rationale for the internal pecking order. If the scheme is well chosen, the factors used will reflect what is important to the success of that employer. Moreover, factor-based job evaluation schemes offer some protection against equal pay claims. This is why, despite the frequent obituaries, job evaluation appears to be alive and well (Amstrong and Thompson, 2003).

What one can therefore expect to see is organisations continuing to balance internal and external relativities. In determining the latter, we have described how the role of the sector is central. For good competitive and practical reasons, organisations will look at how other similar employers pay. However, organisations would be wise to look further. For lower-level staff, sector is likely to be far less important than location. These people cannot afford to travel far and so will look in their local town for employment. This may well cut across sectoral boundaries. Employees may be prepared to switch from a shop to an office to a factory. By comparison, other professional groups will only move within their occupation and, at higher income levels, they may become very mobile.

The conclusion one can draw, is, as ever, that setting your remuneration policy is a matter of horses for courses. Different approaches may be needed for different groups. This applies to both the relative importance given to external and internal equity, and to the different types of external referent. What is required is judgement. This is particularly true when looking at external market data. This is a matter, as Gomez-Mejia and Balkin (1992) said, of a combination of art and science, though some might regard this as more of a black art! Managers should not believe that when the markets speaks, all they have to do is listen. They must use more of their critical faculties to get the right sort of answer. This is why devolving pay decisions to line managers can be problematic. It is necessary to give managers all the data they need, but they have to be skilled to use the information.

This suggests that HR still has a vital role to play in contributing to the development of remuneration policy, the acquisition of robust (or at least as robust as possible) pay data from various sources, and support to managers who are exercising judgement in the use of that data. The HR function, too, can help the organisation recognise the impact of the external environment on its reward options. This includes the impact of government regulation. For example, the national minimum wage has clearly affected pay levels at the bottom end of the market. Organisations need to acknowledge that the labour market is not static. Not only does unemployment rise and fall and earnings-growth ebb and flow, but also what employees want from work alters. A case can be made that organisations can expect higher wastage, as loyalty to the employer becomes more conditional and employee demands grow. Staff may only stay if they get what they want, and this may include a broader deal — not just money and a career, but also benefits and work satisfaction. This suggests that employers will need to take a more holistic view of what attracts and locks staff in. It may be that market alignment means more than money, and that organisations may have to emphasise their values as much as their cash.

4.7 References

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