Paying for
Organizational Performance

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ABSTRACT

The advantages and disadvantages of basing bonus payments on organizational performance are considered. Gainsharing is evaluated as is profit sharing. It is concluded that they serve different purposes and when combined they can have a positive impact on organizational performance. Performance improvement is particularly likely when participative management is practiced and other policies are changed.
PAYING FOR ORGANIZATIONAL PERFORMANCE

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Bonus payments based on the performance of an organization are an old and potentially quite effective way to improve organizational performance. Proponents argue that they can improve motivation, build a work culture in which people are committed to and care about the organization's effectiveness, and finally, adjust the labor costs of an organization to its ability to pay. There is no question that in a number of instances, organizations have been able to accomplish just these outcomes as a result of paying bonuses based on organizational performance. However, it is far from simple to design an effective bonus plan.

There are literally thousands of approaches to paying for organizational performance, and there are many complex organizational issues that must be dealt with if a plan is to be successful. The good news is that decades of research have pointed out a number of things that must be done if plans are to be successful, and as a result, designing a plan or plans does not have to be an unguided trip for an organization.

Historically, there have been two major approaches to paying for organizational performance. The oldest is the approach of paying bonuses based on the profitability of the organization. This is undoubtedly the most widely accepted approach around the world, and as will be discussed later, has important advantages, as well as some very important major limitations. Less well known but increasingly popular
is gainsharing. Gainsharing differs from profit sharing in two respects.

First, it is always combined with a participative approach to management, and secondly, it typically measures controllable costs or units of output not profits in its approach to calculating a bonus. We will first consider what is known about gainsharing, and then consider profit sharing. Once we have done this, we will be in a position to consider what an organization should do, if it wants to base pay on organizational performance.

**Gainsharing**

Gainsharing has been around for at least 40 years. It has been successfully applied by hundreds of organizations.\(^1\) Employees and companies have profited from gainsharing, companies in the form of reduced costs and employees in the form of bonus payments and improved job satisfaction. The original and best-known gainsharing plan is the Scanlon Plan. Other gainsharing plans include Improshare and the Rucker Plan. In addition to these plans, many companies have their own gainsharing plans which are custom-designed.

In the typical gainsharing plan, financial gains in organizational performance are shared on a formula basis with all the employees. A historical base period is established and is used as a basis for determining whether gains have occurred; hence the name "gainsharing." Typically, only controllable costs are measured for the purpose of computing the gain. Unless a major organizational change takes place, the historical base stays the same during the entire history of the plan; thus, performance is always compared to the time period before starting the gainsharing plan. When performance is better than it was
in the base period, a bonus pool is funded. When it falls short no bonus pool is created. In the typical plan, at least half of the bonus pool is paid out to the employees, while the rest is kept by the company. Payments are typically made on a monthly basis with all employees getting equal percentage amounts.

No one has an accurate estimate of how many gainsharing plans there are in the United States and Europe. There certainly are at least a thousand, and there seems to be little doubt that their popularity has increased tremendously in the last ten years. One recent survey in the United States indicated that about 13% of all firms have them, and that over 70% were started in the last five years.\textsuperscript{2} The White House Conference on Productivity, the U.S. government's General Accounting Office, and the President's Task Force on Industrial Competitiveness have all recently endorsed gainsharing.

Until ten years ago, gainsharing was used primarily in small manufacturing organizations. Much has been written in the United States about the success of gainsharing in such companies as Herman Miller, Lincoln Electric, and Donnelly Mirrors.\textsuperscript{3} All three of these plans are over thirty years old. During the 1970s, an interesting and important trend developed. Large companies such as General Electric, Motorola, TRW, Dana, and Firestone began installing gainsharing plans in some of their manufacturing plants. The trend of large corporations defining organizational units which have their own gainsharing is continuing, and is resulting in the adoption of many more gainsharing plans. Dana and Motorola, for example, now have virtually all of their employees covered by gainsharing.
The increased popularity of gainsharing is significant, and relates to an important feature of most gainsharing plans. They are more than just pay incentive plans; they are a way of managing and an organization development technology. To be specific, they are a participative approach to management and are often used as a way to install participative management.

The Participative System

From the beginning, Joe Scanlon, the creator of the Scanlon Plan, emphasized that gainsharing fits a participative management style. In many cases, participative systems are needed in order for the plan to work, and in all cases, they are needed in order for the potential of the plan to be realized. In the absence of a change in employee behavior, there is no reason to expect a payout from the kind of formula which is typically developed in gainsharing plans. A payout requires an improvement in performance, and that improvement requires more effective behavior on the part of employees.

Some improvement may be gained simply from the motivation that is tapped through typing pay to performance. This is particularly true in situations where the work is not highly skilled or interdependent and, as a result, effort is directly related to performance. In other situations, however, there are several reasons why a gainsharing plan without a participative system will not produce an appreciable improvement in performance.

First, the motivational impact of the plan may not be large because most gainsharing plans aggregate a number of people together. As a result, the plan produces only a small increment in the perceived relationship between individual performance and pay. The formula used
is also relevant here. Some plans use very simple formulas that focus on the relationship between labor input and productivity, while others use a comprehensive set of cost measures. Simple labor based plans are more likely to affect motivation because with them, employees can see a more direct relationship between their efforts and their bonuses. Despite their attractiveness, as will be discussed later, simple plans are not always best from an organizational effectiveness point of view.

Second, in many cases, simple effort and good intentions are not enough to improve the operating results. What is needed is a combination of people working harder, working more effectively together, sharing their ideas, and working smarter. In order for this to happen, if often takes a formal participative system that converts the motivation to improve into actual changes in the operating procedures of an organization. In the absence of new procedures or systems to accomplish these changes, they rarely seem to occur.

In traditional gainsharing plans such as the Scanlon Plan, the key to the participative system is a formal suggestion system with written suggestions and shop-floor committees to review the suggestions. Often, there is also a higher-level review committee that looks over those recommendations that involve several parts of the organization and/or large expenditures. This system of committees is one way of trying to assure that new ideas will be seriously considered and, where appropriate, implemented. Recently some companies such as TRW, have combined gainsharing with highly participative management practices to produce an approach which is best called high involvement management. In this approach employees make most of the operating decisions and get
rewarded for their organization's effectiveness through the gainsharing plan.

Research Results

The most important thing we know about gainsharing plans is that they work. Table 1 lists some of the common results that have been found in research studies of gainsharing plans. As can be see, they typically produce a number of positive results and, in fact, research supporting this point has been around for quite a few years. We know somewhat less about the frequency with which they work, but even here there is evidence to suggest that they work in a relatively high percentage of the cases (about 70%).

Quite a bit is also known about how to structure gainsharing plans. There are a number of books and articles which describe in some detail how to put together formulas, how to introduce plans, and how to manage the process side of things. As a result, there is quite a bit of "hot-to-do-it" knowledge. This is particularly true with respect to the Scanlon Plan. Indeed, careful reading of the literature on this plan can make it possible for the skilled practitioner to develop and install a plan without the help of a consultant (most plans, however, are installed by consultants).

The research evidence also shows that certain situational factors favor gainsharing plans. They include:

1. **Organization size.** The plan is based on employees seeing a relationship between what they do and their pay. As organizations get larger, this is harder to accomplish. Most successful gainsharing plans cover less than 500 employees.
2. **Performance measurement.** In some organizations, good performance measures and a reasonable performance history simply do not exist and cannot be established. This is often true in organizations where rapid technological and market changes occur. When this is true, gainsharing plan formulas are difficult to develop.

3. **Measurement complexity.** Often performance can be measured only in very complex ways. The truer this is, the more difficult it is to make a plan work, because there is no clear, easily understood connection between an individual's behavior and rewards.

4. **Worker characteristics.** Gainsharing depends on workers wanting to participate and wanting to earn more money. Admittedly, most workers have these goals, but not all do. Unless a substantial majority of the employees want the benefits the plan offers, it cannot succeed.

5. **Communication.** For gainsharing to work, employees must understand and trust it enough to believe that their pay will increase if they perform better. For this belief to exist, a great deal of open communication and education is needed. If an organization does not have these already, they must be started if the plan is to succeed.

6. **Management attitudes.** Unless managers are favorable to the idea of participation, gainsharing will not fit the management style of the organization. In some organizations, the plan has been tried simply as a pay incentive plan without regard to management style, and it has failed because of a poor fit.

7. **Supervisory skills.** Gainsharing requires supervisors to change. They are forced to deal with many suggestions, and their competence is tested and questioned in new ways. Unless supervisors are
prepared for and accept these changes, the plan can fail. This point goes along with the general point that management must be prepared to manage in a different way.

As this list demonstrates, gainsharing does not fit every situation. Since they often have most of these favorable conditions it is easy to see why, for so long, the installation of gainsharing plans was limited to manufacturing situations. Recently, this has changed. Some service organizations such as banks and hospitals have begun using gainsharing plans. A good guess is that over the next five to ten years there will be increased use of gainsharing plans in nonmanufacturing situations. Although a great deal remains to be learned about how such plans should be installed in nonmanufacturing environments, it appears there are ways it can be designed to work in these settings. Indeed, it may be a more broadly applicable approach that has been assumed. As will be discussed next, as long as some basic design features can be built into a plan, there is reason to believe it can work in many situations.

Critical Gain Sharing Elements

The design of a gainsharing plan for an organization is part science and part art. Because there are so many different gainsharing plans around, it is easy to lose track of what the key elements are that make for a successful gainsharing plan. Perhaps the key issue in gainsharing design is that of fit. The formula and participative management features need to fit each other and the situation. Given the variety of situations in which gainsharing plans have been installed, it is not surprising that a wide variety of plans have been tried. Different situations require different designs; different designs
require different practices. There are, however, some elements which are needed in all plans if they are to be successful. Let us turn to a consideration of each of the elements and look at how they can be achieved.

Credible, Trusted Development Process. Gainsharing plans vary widely in how they are developed. In some cases, a knowledgeable expert comes with an already developed plan and convinces the organization that it will work for them. In other cases, representative task forces are created within the organization. They investigate different plans and ultimately end up making a recommendation for their particular situation. There is no right set of practices, but it can be stated that unless the practices are ones that lead to employees believing in the plan, it has little chance of success. Plans depend on employees believing that if they perform better, they will be paid more. Initially, this requires a leap of faith, because there is no payment until there is performance improvement. Although in some cases an outside expert can effectively sell a plan to an organization, a good guess is that in most cases, a participative development process that utilizes a task force is most likely to lead to a high level of plan acceptance.

Understandable/Influenceable Bonuses. If a gainsharing plan is going to increase motivation, employees must have both a line of sight and a line of influence to the bonus. In short, they must be able to see how through their behavior, they can influence the size of the bonus. Achieving this, particularly in a complex organization, is not simple. It is a matter of education, communication, and the development of a good approach to determining the size of the bonus.
Typically, in gainsharing plans, a formula is used to calculate the size of the bonus. This has the obvious advantage of being much more objective than the alternative which is a discretionary decision about how much the bonus will be. We cannot rule out judgment as a possible vehicle for deciding the bonus, however. There may be situations which, because of rapid change or complexity, do not lend themselves to a formula. If a valid, trusted decision process can be developed it is still possible to have an effective plan. In some cases, for example committees have been successfully used to make bonus decisions while in others a trusted top manager has made them based on pre-set objectives.

Any discussion of formula raises the question of what to measure. Some advocates of gainsharing push strongly for simple plans operating on the principle that, it is always best to keep plans simple. For example, some plans simply measure the number units of output per labor hour. These plans are effective in situations where labor costs are the key issue and the business is a very simple one. In most cases, however, ignoring other costs such as materials and supplies can be quite dangerous and counterproductive. Thus, in many cases, the formula needs to include, multiple costs in some form or another.

Every bonus type plan must have a standard that triggers payment. Many profit sharing plans use a financial break even point or a certain return on investment. As noted earlier, gainsharing plans typically use a historical performance level. There are a number of advantages to using historical performance, particularly its credibility. It is credible in the sense that employees know it can be achieved, and they understand where it came from. It is not an "arbitrary number" based on some economic concept like return on investment or an estimate by
someone of what performance should be. It is also often desirable from an organization's point of view because improvement over it represents real improvement in organization performance and it is possible to argue that any bonuses are self funding because without improvement there are no bonuses. It is not, however, the only correct basis for a standard.

In the case of an organization that is on a learning curve, historical performance may be too easy to achieve and thus, some projections of the learning curve may be needed. In situations where there is a dramatic change of products or technology, history may no longer be a relevant basis for setting the standard and some other more subjective approach such as a committee decision may be required.

Timely Bonuses. Gainsharing plans, typically pay bonuses on a monthly basis. There is no magic in monthly payments. The important principle is that bonuses should be paid as soon after the performance as possible. In situations where the work process is simple, a month may be the right time period. In other more complex situations, however, a month may not be long enough for the organization to complete the production of the product or the delivery of a service. In this case, quarterly or even semiannual bonus payments may be the right time period.

Comprehensive Measures. In simple manufacturing situations, a simple formula often is quite appropriate. However, it can be dangerous in situations where multiple controllable costs are involved in the business. Focusing on any cost can lead to employees' reducing it while increasing other. Thus, the key issue in deciding what to measure for the purposes of a gainsharing plan is zeroing in on all the controllable costs. This may lead to a more complex plan, but it is much better to
have a complex plan than one which is not dealing with the true complexity of the business. Simple plans are great for simple businesses, but complex plans are needed for more complex business situations.

**Involvement Opportunities.** Employees need to be able to influence the measures which are used as the basis for calculating the bonus. This has some direct implications for the kind of participative management models which fit different bonus formulas. If the bonus is based on labor cost only, then often the kind of suggestion program which is used in Scanlon companies is quite appropriate. Through written suggestions, employees can come up with work method improvements which speed production and reduce labor costs. However, if the gainsharing formula is a complex, multiple cost one, then different forms of employee involvement are needed so employees can influence the payout. Employees need to be able to influence not just direct production decisions, but decisions involving other costs such as materials, supplies, inventory, and so forth. In order to accomplish this, work teams and task forces to look at major business decisions may be needed.

There is no right formula for employee involvement, the key is fitting the employee involvement approach to the formula, which in turn needs to fit the business situation. Simple business situations can use simple formulas and basic approaches to employee involvement. More complex business situations require more complex gain sharing formulas and higher levels of employee involvement. **Maintenance.** All gainsharing plans require some approach to maintenance. Businesses change, environments change, and as a result,
formulas and involvement approaches need to change. Typically, the key to a successful change, is that it is timely and, is done in a way which employees see as credible. Typically, this is handled by an ongoing task force which has representatives from all levels in the organization. This group regularly reviews the plan, and recommends changes.

The alternative to an ongoing task force is to have an outside expert come in and update the plan on a regular basis. This can work, but it has the disadvantage of making the organization dependent on an outsider and it is possible that the outsider will not be as credible as an internal group. The key, to a successful internal group is that it be staffed by trusted, knowledgeable individuals who understand the business and are capable of making good decisions and communicating them to the rest of the workforce.

**Profit Sharing**

Profit sharing is better known, older, and more widely practiced than gainsharing. In the United States, for example, data indicate that at least one third of all organizations have profit sharing. In Britain, the Treasury is studying profit sharing with an eye toward encouraging its widespread adoption. Some definitions of gainsharing include it as a form of gainsharing; however, it is different in two respects. It often does not have a participative management component and it does not use formulas which only measure increases in employee controlled financial, or productivity related, performance. Profit sharing plans typically are much less effective than gainsharing plans in influencing motivation and in producing the kind of social and cultural outcomes listed in Table 1. This is particularly true in
large organizations where the line of sight and line of influence from individual performance to corporate profits is virtually nonexistent.

In the typical profit sharing plan the line of sight problem is even further compounded because most firms (estimates are about 85%) defer profit sharing bonuses by putting them into retirement plans. This compounds the problem of tying present rewards to present controllable performance to the point where it is hard to see that there can be any impact on motivation and employee behavior.

Before we dismiss profit sharing as being completely useless from an organizational effectiveness point of view, there are three things that even a deferred profit sharing plan in a large corporation can accomplish. First, there is some potential symbolic and communications value in paying people based on organizational performance. It can effectively point out to everyone that they are part of the organization and that cooperative effort is needed. Since corporate executives are often paid on the basis of profit sharing, it can also help to assure that there is an alignment between the rewards received by top management and those received by people throughout the organization. This can help avoid the all too common problem of executives getting large bonuses, while lower-level employees receive none. This has often happened in such large corporation as Ford and General Motors. Recently, General Motors appeared to have solved this problem when they put all employees on profit sharing, but they made the mistake of creating different plans for managers and union members. So far, the plans have treated the executives better than they have treated the unionized employees, further polarizing the situation.
Secondly, some companies, most notably Hewlett-Packard, have effectively used their profit sharing plans as vehicles for educating employees about the financial condition of the business. When employees are actually sharing in the profits, it brings alive for them the issue of what profits mean, how they are calculated, and can increase their interest in learning about profits and organizational effectiveness.

Thirdly, perhaps the most important advantage profit sharing offers is that it makes the labor costs of an organization variable, and adjust them to the organization's ability to pay. When profits go down, labor costs go down, and thus, rather than being fixed, labor costs, at least in part, become variable. This is a particularly desirable feature for organizations that are in cyclical or seasonal businesses. In most western countries, changes in labor costs are handled through increases and decreases in the size of the workforce. This is a necessity when wages are high and fixed, because there is no other way to reduce labor costs to reflect the company's ability to pay. With profit sharing, it is possible to reduce costs significantly without reducing the number of employees. Most Japanese companies have used this approach to controlling cost for decades. As is the case in Japan it can allow an organization to make a much stronger commitment to employment stability and help it gain the advantages which are inherent in having a stable workforce.

A key issue with profit sharing is just how much of an individual's pay is at risk through the profit sharing plan. In Japan, it is often a large percentage of the person's pay, as much as 30% to 40%. This gives them a significant cushion and helps make their guaranteed employment model work. This is probably too great an amount for most western
countries, but it is possible that a company could operate with 10% to 20% of total compensation dependent on profit sharing.

**Designing an Effective Performance Pay System**

Our analysis so far suggests that both gainsharing and profit sharing can be useful practices for most organizations. Interestingly, it suggests that they ought not to be looked at as competing approaches, but as compatible approaches which accomplish different, important objectives. Profit sharing can have the desirable effect of creating variable costs for an organization, thus allowing it to adjust its costs to its ability to pay. It can also affect the communication pattern and culture of an organization in ways that emphasize the performance of the total organization. Gainsharing, on the other hand, if correctly designed, can provide motivation and produce a culture in which people are committed to seeing their organizational unit operate effectively.

The ideal combination for many large corporations would seem to be a corporate-wide profit sharing plan and gain-sharing plans in major operating plants or units. Just this type model is starting to emerge in such U.S. corporations, as Xerox. The combination of gainsharing and profit sharing deals direct with the need to have costs variable and the need to motivate employees. Gainsharing alone does not do this because it tends to be based on subunits of the organization and measures which do not include all the operating costs of the business. Thus, the possibility exist for it to payout a bonus when the organization is performing poorly and vice versa. From the motivational point of view, this is quite acceptable if the employees are performing well against the things that they are measured upon and can control. In the absence of the profit sharing plan, employees may erroneously feel that the
situation is in good shape since they are receiving a bonus. The addition of a profit sharing plan can help the organization call attention to the fact that the organization's performance is not satisfactory. It also can adjust labor costs according to the organization's ability to pay, something a gainsharing plan may not do.

The amount of profit sharing and gainsharing money which is paid out in an organization needs to vary according to a number of factors. In most cases it probably should not be the same for all levels in the organization. At the lowest level, gainsharing should potentially produce larger payouts than the profit sharing plan. The emphasis here is on potential since the actual amount is determined by performance. The logic is that gainsharing is easier for lower level employees to relate to and significant money must be involved for it to be motivating. At higher levels of management, the situation is different, and perhaps profit sharing should have the greatest payoff potential. Some organizational conditions are also relevant here. The more interdependent the different units of an organization are and the smaller the organization is, the more profit sharing should come into play. The logic here is that the more these are true, the easier it is for employees to focus on organizational performance and the more important it is to focus on it.

**Supportive Reward System Practices**

As has already been emphasized, gain sharing is not a stand-alone practice. To flourish, it needs to be combined with a different approach to management and communication. In a similar way, to be optimally effective, organizations which adopt a combination of profit
sharing and gainsharing need to develop educational and reward system practices which are supportive.

Not only do employees need to be educated in the economics of the business so that they can understand how profits are measured and achieved, they need to be educated in how the organization works. A helpful change in this direction is a move to knowledge or skill-based pay. In this pay system people are paid according to the number of skills and amount of knowledge they have. Everyone is required to learn multiple skills. As individuals master new jobs their pay increases, creating a strong incentive to learn. Training is available and employees are encouraged to rotate jobs and to continually learn. This helps employees understand how the organization works and how they can influence its performance--key factors in making gainsharing plans successful. It also gives them a higher level of commitment to improving performance.

A guarantee of employment stability is critical to the success of pay plans which are based on organizational performance. If employees fear that they will lose their jobs because productivity improves and they are no longer needed, they will not be motivated to contribute their ideas and to work harder. Employees at least need to be guaranteed that they will not be laid off as a result of the improvements that result from their efforts. If financially reasonable, it is also desirable to assure employees that layoffs are one of the last approaches the organization will use to reduce costs. With an employment guarantee, employees see a fair trade-off: employment stability in exchange for the fluctuating compensation inherent in profit-sharing and gainsharing.

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Performance based pay can be disruptive to people's personal lives because it creates income variation. Although profit sharing is not as disruptive as the layoffs that many companies use to cut costs, several steps should be taken to help employees cope. Personal financial counseling and education are a must. Employees may not know how to budget and manage their expenses when they have a variable income. Years ago in the United States, Kaiser Steel failed to do this when it introduced a profit-sharing plan; the result was considerable hardship when profits dropped. People had made financial commitments they could not keep.

Flexible benefits are also a nice complement to profit sharing. They allow employees to adjust the mix of cash and benefits they receive to fit their particular needs. Employees are given an amount of money which they can take in cash or spend on any combination of the usual array of company benefits. For example, in companies like TRW, employees can choose among different kinds of health insurance and different amounts of retirement, to mention just two of their choices. With variable income, people's needs obviously are going to change, and it makes sense to let them adjust their pay and benefit package to fit their current income level. So far, few companies have combined flexible benefits and profit sharing, but flexible benefit plans are increasing in popularity because they have many advantages of their own.

Conclusion

Overall, the evidence is clear: basing pay on organizational performance can lead to a number of positive outcomes for both employees and organizations. However, it is not a quick fix or panacea for the ills of an organization. Careful design is critical and, in most cases,
a number of other changes are required if all the advantages of performance-based pay are to be realized. If a heavy commitment is made to gainsharing and profit sharing, then considerable education, communication, and power sharing may need to occur. In addition, organizations may need to work on employment stability guarantees, and develop knowledge-based pay systems. In short, paying for organizational performance is more than a pay approach, it is an approach to management that must be combined with a congruent management system.
### TABLE 1

RESULTS OF GAINSHARING

1. Coordination, teamwork, and sharing of knowledge are enhanced at lower levels.

2. Social needs are recognized via participation and mutually reinforcing group behavior.

3. Attention is focused on cost savings, not just quantity of production.

4. Acceptance of change due to technology, market, and new methods is greater because higher efficiency leads to bonuses.

5. Attitudinal change occurs among workers, and they demand more efficient management and better planning.

6. Employees try to reduce overtime; to work smarter, not harder or faster.

7. Employees produce ideas as well as effort.

8. When unions are present, more flexible administration of union-management relations occurs.

9. When unions support the plan, they are strengthened because a better work situation and higher pay result.

10. Unorganized locations tend to remain nonunion.
REFERENCES


