

# APEC Conference

APEC Conference, Productivity Based Compensation

This paper was delivered to the conference held in Kuala Lumpur, Malaysia by Paul Phillips of Horizon Management Group on April 20th, 2004.

## Aim

The aims of this presentation on productivity and compensation are to:

1. Provide information on the Australian background so it is possible to select the best practices and possibly avoid productivity and compensation traps at a national level.
2. Describe the general productivity and compensation practice of some progressive organisations in Australia, which are fairly international, so that elements of these can be adopted by others.
3. Discuss the other factors that may affect productivity and how compensation relates to these.

## Current Performance of Australia

Australia is performing quite well at present compared to major trading partners and other OECD countries.

Australia has just had another good year with a GDP growth of 4%. While this is not as high as Malaysia's recent achievement of 5.2% it means our productivity growth has nearly doubled over the past decade which outpaces America's. *The Australian* newspaper said recently this is:

"...continuing 13 years of economic expansion. The economy is growing and the corporate sector is enjoying a bigger share of the economic cake.

Behind it all is a powerful combination of international good fortune – rising world commodity prices, the world economic recovery since mid 2003 and the booming industrial demand in China – with structural forces which have been driving corporate Australia and reshaping the Australian economy. There was the removal of tariffs and the opening up of the economy in the 1980s and 90s under the Hawke and Keating governments, and deregulation of the labour force and the shift from national awards to workplace bargaining and individual contracts under the Howard Government" *The Australian March 6-7 2004*. On top of this our jobless rate is the lowest it has been for 20 years.

While researching this paper I visited the website of the Department of Employment and Workplace Relations. There were about 500 press releases going back to mid 2000.

Of these about 30% were on working for the dole ie unemployed people working on special projects before being able to collect unemployment benefit.

About 3% were on unemployment.

There were none on productivity.

However, to be fair, the Department of Employment and Workplace Relations do not claim that this is their job. The welcome message on the website from the Minister says:

“As Federal Minister for Employment and Workplace Relations, my number one goal is to create more jobs and higher wages for more Australians.

Having a job provides far more than financial rewards; it is vital to a person’s dignity and sense of worth and means greater security for Australian families and a higher standard of living for all.

I am responsible for the Australian Government’s employment programmes as well as workplace relations policies.

The Government believes employers and employees are best placed to directly negotiate their conditions at the workplace level. They can decide what is best for them.

Our policies aim to create more flexibility and choice for employers and employees.”

So, I think we can safely say that on our subject of productivity and compensation the government is not directly involved. However, it is trying to remove barriers and allow employers and employees to reach their own agreements.

### **Brief History of Australia**

To understand some Australian practices we need to cover a piece of history and set the context. Australia’s history falls into two distinct categories – Aboriginal and European.

Europeans thought they discovered Australia in the early 17<sup>th</sup> century and there is still some debate about which European was first. We wonder why our indigenous people get upset – they have been there for about 60,000 years.

European settlement was unusual. The first settlers were public servants and convicts. This is why Australians are always surprised by how lucky we are. Apparently the British thought it was a good place to dump their problems.

That first settlement, the colony of NSW was in 1788. Other colonies followed: Tasmania, Western Australia, South Australia, Victoria and Queensland. They continued as separate colonies until 1901 when they united in a Federation to form the Commonwealth of Australia. So, Australia as a nation is only 103 years old.

### **Brief History of Industrial Relations in Australia**

On the subject of productivity based compensation, to compare Australia to the USA is interesting. We are a similar sized land mass but with a much smaller population. We were founded by a group of people very much into control – guards and prisoners. In contrast, the US was founded by people escaping control and seeking freedom. It is not surprising then that the 20<sup>th</sup> century in Australia was very much about centralization and regulation in the pay area - control.

Australia inherited the British tradition of craft unionism and also developed its own brand of industry unions. During the last century unions have had a high level of legal recognition. Various boards and tribunals were formed by the colonies to assist in resolving industrial issues and in 1904 a Commonwealth Court of Conciliation and Arbitration was formed.

This evolved over the years to our current Australian Industrial Relations Commission. This ensured a reasonable level of fairness and stability as it could hand down binding decisions when parties could not agree. We still have State legislation and tribunals. We really have seven industrial relations systems!

Australian industrial relations have been largely regulated by the award system in the past.

Awards are industrial agreements that bind groups of workers in similar jobs and respondent groups of employers. Eg Metal workers, plumbers, clerks, transport workers, building workers.

They have provided a safety net of minimum conditions and pay. Some businesses elected to pay more when they could afford to or when they had to through industrial pressure.

Increases to these minima were awarded each year in the National Wage case where employers and unions would argue their cases and the Commission would determine the increase to the rates of pay in the awards. These increases would generally apply to all rates even if the company was already paying above the minimum.

Over time, awards became more detailed as various clauses were added – some of them quite restrictive in terms of conditions, work practices and penalty rates. Some businesses could agree to terms which others were unable to meet. Some awards had maximum levels of pay that could not be exceeded.

### **Recent changes**

In the early 1980's there was a need to make changes to the existing system to provide international competitiveness. There was pressure to have *enterprise level agreements* rather than those covering a whole industry.

The first step in introducing these changes was the 1987 Restructuring and Efficiency Principle which provided a two tier increase - \$10 per week increase across the board plus 4% for improvements in work and management practices, multiskilling and broadbanding of pay scales.

In 1988 this principle was continued with a 3% maximum increase for productivity offsets. This made it possible for some workers to have no increase at all if there were no improvement in the work practices in their awards.

In 1991 the Enterprise Bargaining Principle was introduced. This continued the reward for improvements but at the enterprise level. A more "hands off" approach was taken by the Commission with no ceiling on increases.

1993 Industrial Relations Reform Act allowed Enterprise Flexibility Agreements. This allowed direct bargaining with employees without the involvement of a union. It introduced the "no disadvantage test" to ensure employees were no worse off than they would be if they were covered by the award. Only 261 of these were ever completed.

In 1996 John Howard's government was elected and The Workplace Relations Act was introduced which dismantled the system and moved primarily to enterprise bargaining. It was aimed at productivity at enterprise level rather than at national level. Awards took on the role of mainly providing a safety net of 20 allowable matters – included in these are hours, rest breaks, minimum pay, leave, penalty rates and dispute settlement procedures.

This Act introduced Australian Workplace agreements (AWAs) which are agreements that can be made between a single employer and employees or groups of employees but are subject to scrutiny by the Office of the Employment Advocate. It must pass a “no disadvantage test” which ensures the employee is no worse off, in total, than he or she would have been under the appropriate award. This allows some of the award conditions to be reduced as long as others compensate. In this way an employer can pay for the removal of some restrictive practices.

### **Current status**

Registered Agreements now cover 37% of employees with approximately 13% of these being AWAs, 21% are covered by awards and 42% by individual contracts. Salaried employees generally have individual contracts. AWAs are still only a small percentage as unions do not support them and argue that meaningful negotiation does not occur at an individual level – it has to be collective.

As at March 2001, only about 9% of certified wage agreements had performance pay clauses. These covered about 21% of employees subject to certified agreements. Even within those agreements, anecdotal evidence seems to suggest industrial pressure is such that if targets are not achieved there is always the chance the blame will be able to be placed back on some management action or inaction and often some way is found to make these payments.

An example of a collective agreement with a combination of performance pay clauses is as follows.

#### ***Private sector - transport and storage division agreement - 1999.***

*Employees' performance pay is conditional on the performance of the individual and work team.*

*Individuals are measured against six performance criteria - safety, equipment damage, rework, attendance at work, blood lead levels and code of conduct. Work team performance is measured by the savings they achieve in monetary amounts. For savings of between \$25 000 and \$49 000 there will be an additional bonus of 1 percent. If savings of between \$50 000 and \$89 000 the additional bonus will be 2 percent. For savings of over \$90 000 the additional bonus will be 3 percent.*

An example linking performance pay to KPIs is as follows.

#### ***Private Sector - Metals manufacturing division, 2000***

*A recent agreement in metals manufacturing provided for two wage increases of 3.5 per cent each year over two years. In addition, the agreement provided for two 2 per cent productivity pay increases over the two years dependant on the achievement of group Key Performance Indicators (KPIs). Two further 0.5 per cent increases were provided for if higher rates than the basic KPI rates were achieved. KPI rates were to be set by the company's Consultative Committee for the following KPIs:*

- Dip rate [of galvanising]*
- Turn around time;*
- Medically treated injury frequency rate; and*
- Numbers of damaged and lost work.*

Where unions are involved, while there are collective agreements that have productivity clauses and KPIs for groups of employees there are fewer for individuals and they are likely to be along the lines of the following example from the public sector.

### **Incremental progression**

*Public sector agreement – Government Administration Division - 1999*

*Performance pay is linked to incremental progression and progression is subject to the completion of training requirements and satisfactory on the job performance. Incremental progression for all employees will be automatic unless assessed as unsatisfactory to progress. If assessed as unsatisfactory to progress, a performance improvement plan will be established.*

### **Opportunities for change**

With our current structure, we have now, in theory, the best of both worlds. A safety net of the award system providing reasonable minimum conditions for all workers and the opportunity for business to have union or non-union agreements either with groups of employees or individuals where productivity pay can be incorporated. However, this can be difficult if the unions have a strong hold within the business.

So, we must ask – why are there unions and why are they antagonistic towards productivity payments? Often these types of relationships are inherited because of the industry the business operates within and often because of past practices and even current practices, where trust has been lost, there is insecurity or management just don't communicate with employees. Unions tend to fill the vacuum left by ineffective management.

Union membership numbers over the years have declined in Australia and in August 2003, there were just under 1.9 million employees who were members of a trade union in conjunction with their main job. This was 23% of the workforce. In 2000 this was 28% and in 1992 40%.

The proportion of full-time employees who were trade union members was higher than for part-time employees (26% and 17% respectively). A higher proportion of public sector employees were trade union members (47%) than private sector employees (18%).

### **Best Practice**

Moving outside of the centralized area we can now discuss best practice in performance related compensation and how this might work within individual organizations.

While the principles we will discuss are not peculiar to Australia, more and more companies are introducing them for salaried employees and often applying them to their wages staff.

Such systems provide pay that reflects:

- the value of the job to the organization
- the market,
- individual performance.

One would think such systems would be wide spread across business in Australia because they make so much sense, however habits developed from the award system are still ingrained and it is still quite common for salaries to be agreed on hiring and annual increases given across the board to everyone based on a perceived increase in the cost of living, the budget or some other external figure.

Progressive companies are making changes and the types of systems being implemented do generally adhere to good salary administration principles.

Effective pay systems generally have the following characteristics.

- ❑ Jobs are defined so employees know what it is they have to achieve and how that is measured. Regardless of the pay issue this is an important subject but there are still organizations that leave this very loosely defined or not defined at all.
- ❑ Some form of evaluation is used to rank or group the jobs from the most important to the organization to the least.
- ❑ Market rates are determined to ensure the organization will be competitive.
- ❑ Individual performance will be a major factor when determining increases.
- ❑ The system will be fair, consistent and transparent
- ❑ It will be easy to administer

On top of this type of system, an incentive program can be implemented that will reward selected individuals or groups of individuals for achieving specific targets – where appropriate.

Let us look at the steps necessary to implement an effective system that will provide compensation that is linked to productivity.

#### Defining jobs

It is necessary to have each job defined carefully. An effective way of doing this is in terms of output and we commonly do this by using Key Results Areas (KRAs) for each job. Typically there should only be six to eight of these and they identify the end result the job needs to achieve rather than the tasks a jobholder undertakes. Alongside these there must be measures identified in advance to indicate what a successful outcome will be.

A simple example is sales. The key result area may be selling cars and the measure may be ten per month. By defining the results areas clearly and having definitive measures all parties know what is expected. Another advantage of defining jobs in this way is that it allows employees some flexibility and creativity in determining how they will achieve results rather than being prescriptive about the tasks they need to perform.

Example KRAs	Example Measures
<p><b>Performance:</b> Ensure performance of the business meets the required level in the short term through optimising the product range, branding, and merchandising.</p>	<ul style="list-style-type: none"> <li>❑ EBIT</li> <li>❑ Cash flow</li> <li>❑ ROI</li> <li>❑ Stock turn</li> <li>❑ Debtors</li> </ul>
<p><b>Reporting:</b> To prepare monthly and daily reports including P&amp;L and cash position to ensure information is</p>	<ul style="list-style-type: none"> <li>❑ Monthly reports completed by 5<sup>th</sup> working day and corrective action taken as agreed with Financial Controller.</li> <li>❑ Daily sales report completed and circulated by 10.30am</li> <li>❑ 100% accurate</li> </ul>

available for all managers to make sound business decisions to deliver the organisation goals.	
<b>Accounts payable:</b> Ensure all accounts payable are paid on time.	<input type="checkbox"/> Goods or services received <input type="checkbox"/> By due date <input type="checkbox"/> No supply halted due to non payment <input type="checkbox"/> 100% accurate
<b>Production:</b> Plan and manufacture products to meet the sales forecasts.	<input type="checkbox"/> Production plan agreed with Sales Dept <input type="checkbox"/> Plan met <input type="checkbox"/> Quality meets Specifications
<b>Processing:</b> Units produced to meet production plan	<input type="checkbox"/> As per agreed production plan <input type="checkbox"/> Units meet specifications agreed <input type="checkbox"/> Wastage within agreed limits

### Job Evaluation

The next stage is to evaluate all the jobs in the organization to determine a relative order of their importance. This can be done with some quite complex job evaluation systems which are fairly common in large organizations or can be completed quite effectively with a more simple system based on similar principles. The principles are to evaluate the jobs based on consistent factors.

The most common ones are:

- Level of knowledge and experience required
- Impact of decision-making
- Problem solving
- Control over resources
- Overall accountability

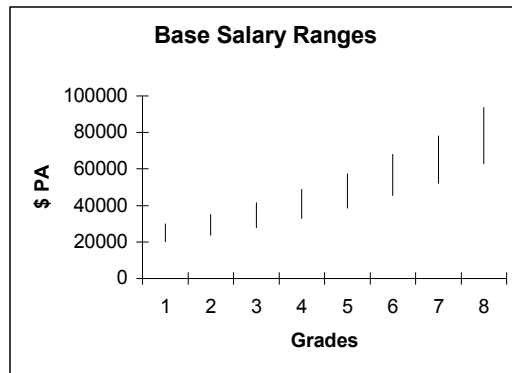
Once this rank order of the jobs has been established they can then be grouped into bands or grades of jobs that have a similar value.

### Market Rates

It is now time to look at the market and establish what salaries or wages are being paid for similar types of jobs by competing employers. This can be done by purchasing a salary survey or by conducting your own.

Once you have collected data on as many of your jobs as possible, and decide where in the market you wish to pitch your salaries, a salary structure can be developed. It is common practice to have a range for each group of the similarly valued jobs and a good rule of thumb is to build

this range around the midpoint using 20% on top of the midpoint for the maximum and 20% below for the minimum. A typical salary structure may then look like the example below.



### Implementing

When existing salaries are plotted on this blueprint salary structure is possible to see where some people are overpaid or underpaid. Actions then need to be taken to correct these or an explanation provided as to why they should be left where they are.

### Reviewing

An essential aspect of remuneration is regular reviews. People need to know this important part of their working life will be examined on a regular basis and linked to their efforts. The first step is to determine the general movement of the market over the review period – normally 12 months. Then the salary ranges (not individuals' salaries) are increased by this amount.

As the midpoints of the salary ranges were taken from the market it is reasonable to expect that someone doing a satisfactory job should get paid somewhere around that part of the range. The common practice has been to allow those people who are above average performers to move to the upper end of the range and those who are still developing or are below average performers to be paid at the lower end of the range.

In order to bring individual performance and market movements together, a matrix can be used as shown below.

PERFORMANCE RATING	POSITION IN RANGE		
	Under 93% of Mid Point	93% to 107% of Mid Point	Over 107% of Mid Point
Significantly Exceeds Expectations	7% - 9%	5% - 7%	3% - 5%
Exceeds Expectations	4% - 6%	3% - 5%	2% - 4%
Meets Expectations	3% - 5%	2% - 4%	1% - 3%
Marginally Meets Expectations	2% - 4%	1% - 3%	0%
Unacceptable Performance	0%	0%	0%

The matrix is constructed by using the general market movement percentage in the middle box, so that if someone is already paid in the middle of the range and their performance is satisfactory they will move in line with the market. However, if they are in the lower part of the range and they are average or above average performers they may receive an increase higher than the market movement. Conversely if they are in the upper end of the range and their performance is not above average their increase may be lower than the market and they will move down the range.

This method ensures that salaries are competitive but are linked to individual performance. Such a system should be linked to a formal performance management system to ensure consistency and fairness.

Performance management, where it is practiced, has normally been about achieving job related goals. More and more companies are moving towards adding competencies to this. So, a job description may show an employee **what** to do and the competencies, or behaviours required to fit with the company's culture or values will show them **how** to do it. In many organisations, this is as important as achieving the more quantifiable goals.

So, if we carefully define our KRAs so they are linked clearly to our corporate objectives and our competencies so they reflect the culture we want, we can build pay for performance, at an individual and organization level, directly into any annual pay reviews.

### **Incentive programs**

In addition to the base salary, which is linked to market and performance, additional incentives can be provided to selected groups or individuals to provide a reward for achieving specific targets.

When designing such programs it is important to determine the objectives carefully. Incentive programs are not necessarily appropriate for all organisations or all jobs.

Normally incentives are introduced in order to achieve some business objectives that would require a change in the behaviour of some employees. This may be focusing on sales, quality, customer satisfaction, on-time deliveries, team-based results or any of a range of other outcomes required by the business.

Just like defining jobs, targets for incentives also need to be clearly defined and measurable. Once the business objectives have been identified the indicators and measures need to be defined.

In developing incentive plans there are certain principles that should be kept in mind.

- 1 Participants must be able to understand the measures and what they have to do to earn an incentive. Does everyone understand how their job contributes to sales if total sales is to be a measure?
- 2 Participants must be able to control the factors that influence the measures, e.g. can they control costs, if profit is to be a measure?
- 3 The measures must link to the corporate objectives. The best incentive plans are those that align with the corporate direction e.g. growth through sales or quality improvement.

- 4 The incentive paid must be meaningful to the employee. It should be a reasonable financial reward that relates to their salary. An incentive that is a percentage of salary is usually best as it can be the same relative importance for all eligible employees. Non-financial incentives such as trips may have a different appeal for individual employees.
- 5 It must be challenging but achievable. A number of periods where no, or little, incentive is paid will quickly be no incentive at all. An easy incentive target will quickly become expected each year and any downturn will create dissatisfaction.
- 6 It should encourage high performers to stay with the Company. It should be rewarding with the chance of it being even more rewarding in the future. Long-term incentive plans can be designed to achieve this more easily than short-term plans.
- 7 The incentive must be within budget constraints. The organisation must be able to pay what was promised without undue hardship. To achieve this it must be included in the budget.

The measures that can be used are endless but the real planning must go into determining what outcomes need to be achieved and how they are going to be measured. It is amazing how many incentive plans fail at this hurdle. Organizations are simply not clear enough about what results and measures they are targeting.

#### Examples of Incentive measures

<b>What needs to be measured</b>	<b>Possible indicators</b>
Sales	Total sales Increase in sales Increase in sales by category
Profit margin	\$ amount % margin
Costs	\$ amount of costs by category Cost of goods Costs of various inputs
New clients	% of sales from new clients Number of new clients Profit from new clients
Customer satisfaction	Repeat business Increase in score from survey Comments/complaints
Quality	Returns Rework Complaints
Project completion	On budget on time

Return on investment	% return Target achieved
Business mix	% of business mix Target achieved
Productivity	Sales per employee Output by time Output by employee
Improvements in processes	Projects completed Costs reduced
Performance v competitors	% of market Change in rank order
Repeat business	Sales from repeat customers
Value of the company	Economic value added (EVA) Share price

**Linking achievement to the reward needs to be carefully considered.**

The amount paid and how it is calculated is important. It may be a percentage of base salary for each milestone e.g. 100% of target, 101%, 102% etc or a flat amount for hitting 100% of target. Should anything be paid for an achievement less than target?

It may be a percentage of above target achievement shared. Eg profit, cost savings or sales. It may be a \$ amount for each achievement eg each new client, project on time or quality target. For new business it may be a percentage of profit from new clients for a certain period. The permutations are endless but it should be transparent and as simple as practicable.

Research also tells us that when a payment is made is important. In general, people respond best to reward when it follows promptly on the actual achievement. A payment calculated 18 months after an event because that's when the final accounts are produced, may sometimes be the only way but it is not desirable for employees.

**The other factors affecting productivity**

It is very easy to just focus on mechanical issues such as pay as if increasing or decreasing pay will increase or decrease productivity. This may work sometimes – but usually only for a short period. It is difficult to sustain a motivated work force just through pay.

Let us turn to a reasonably well known piece of motivation theory. Frederick Herzberg's work on motivation in 1966 is one of the more useful for helping managers. He was interested in the importance of work and working conditions to working people. His study covered 300 accountants and engineers and collected information on what experiences made them feel good about their jobs and what made them feel bad. Factors were uncovered which influenced job satisfaction. What was surprising about the analysis was that the factors which led to satisfaction were different from those which led to dissatisfaction. This led him to believe that the opposite of job satisfaction was not dissatisfaction but rather just no satisfaction.

Herzberg divided the various factors into two groups – **motivators** – those factors which made people feel good about work, and **hygiene factors** – those which, if they are present, can prevent loss of morale, but, by themselves, cannot cause good morale or productivity. Being hygienic can stop you getting sick but will not necessarily make you healthy!

#### *Motivators*

- ❑ Sense of achievement
- ❑ Recognition of achievements by seniors
- ❑ Being given responsibility
- ❑ Advancement and promotion
- ❑ Awareness of prospects for further growth
- ❑ Interesting work

#### *Hygiene Factors*

- ❑ Poor features of an organisation's policies or administrative procedures
- ❑ Poor quality of supervision
- ❑ Difficult relationships between staff
- ❑ Anxieties about security or status
- ❑ Salary
- ❑ The impact of the job on the personal life of the individual

Inadequate hygiene factors can cause negative attitudes, but adequate ones have no effect on productivity.

Motivation is not increased by paying people well or by providing attractive benefits. Such elements are necessary to maintain a level of productivity but will not, by themselves, lead to job satisfaction. This is why, when an employee resigns or threatens to resign, a pay increase rarely keeps them long term. Long after the euphoria of a pay increase has disappeared, the original reasons for the dissatisfaction linger on.

The motivators tend to be more job orientated and therefore within the control of individual managers while the hygiene factors tend to be more organisation wide. This does not mean they are absolved from the responsibility of removing any frustrating influences: rather, it demands that they work harder at doing so.

In practical terms, what can we, as managers, do about it? Let's look at those factors again.

Achievement - are there opportunities available for employees to achieve higher and higher levels of success?

Recognition - do employees receive recognition for their contributions – formally and informally?

Work itself- is the work challenging and fulfilling? Can it be modified to provide more challenge either through a wider range of tasks or a greater requirement for skill?

Responsibility - can employees be given more responsibility for some of their tasks or decision making?

Advancement - are there opportunities to provide advancement for high performers into positions of greater responsibility? Can their jobs be changed to give them this advancement?

So, pay is still important, but it cannot stand alone and be sustained as the only productivity tool. We need to put everything in context.

With regard to these “softer” factors in Australia – it seems that employers who want to compete for talent are being forced into examining them. The younger people coming into the work force have seen their parents work hard, sacrifice plenty and then be thrown on the scrap heap. They are looking for what is being called a work/life balance and flexible hours. They also have high aspirations and expect advancement if they perform. If it doesn't happen, they are very mobile and they leave. With our low unemployment rate and continuing need for talent, employers have to address the factors that will lead to employee satisfaction. Some are actually doing this but others seem to accept a certain level of staff turnover as an unavoidable cost.

We certainly have room for improvement. Out of the OECD countries only Australia and the USA do not have any public maternity leave programs and Australia has very little public provision for childcare. For those under three – only 2% were in publicly funded childcare. These are issues that need to be addressed to encourage females back into the workforce.

### **Summary**

The Australian experience seems to have been shaped by a highly centralized and regulated system that provides a certain amount of stability and protection for workers by establishing minimum wage rates and working conditions.

Within the last 20 years this has been freed up to a level where it still provides protection for employees but allows individual organizations to negotiate flexible arrangements with employees.

Organizations are moving towards more sophisticated wage and salary systems based on job value, market rates and individual performance.

In addition to base wages and salaries some organizations also have designed incentive programs which are aimed at rewarding individuals or groups of employees for achieving certain objectives.

Many of these base pay and incentive programs are common to other countries but are being reinforced through the growing global nature of many organizations.

In addition to pay, employers are forced to look at all factors which are likely to impact on employee satisfaction, motivation and productivity. This is a continuing challenge in Australia and likely to be the same in other economies.

Sources of information:

Department of Employment and Workplace Relations

Department of Foreign Affairs and Trade

Australian Bureau of Statistics

Industrial Relations – A Contemporary Analysis – *Deery, Plowman, Walsh, Brown*

BIS Shrapnel

The Australian Newspaper