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WHO HAS FLEXIBLE WAGE PLANS AND WHY AREN'T THERE MORE OF THEM?

by

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There has been renewed interest in "flexible" compensation plans in recent years. Some of this interest is due to concerns about poor U.S. productivity performance. Some of it stems from theoretical analysis by Weitzman and others suggesting that macroeconomic problems (unemployment, inflation) could be alleviated by certain kinds of flexible pay systems.[1]

Four types of plans are commonly lumped under the flexibility label. These are 1) simple incentives such as piece rates, 2) gain sharing plans (Scanlon, Rucker, Improshare), 3) employee stock ownership plans (ESOPs, tax-credit ESOPs), and 4) profit sharing plans. Unfortunately, discussion of these plans is frustrated by lack of consistent, basic data on the extent to which these plans are actually used. Moreover, the tendency to lump the plans together obscures their differences.

In this paper, three issues are examined. First, available evidence is examined concerning the use of flexible pay systems. Second, management beliefs about the attributes of the plans are explored, based on a survey conducted by the authors. Third, the question of perceived substitutability between the alternative plans is discussed, using the survey. This last question is important due to the Weitzman argument that all plans are not created equal. If having one type of plan precludes having another, then it will be difficult to encourage establishment of those plans which have desirable economic properties.

I. TYPES OF PLANS.

<u>Simple incentive plans</u> began as piece rates in early

manufacturing settings. Such plans still exist. But as scientific management developed in the early part of this century, more elaborate systems evolved (Bedaux, Halsey, Rowan, and Gantt plans). A typical plan involves a production standard with worker bonuses for meeting or exceeding the norm.

Compensation specialists often argue that simple incentives provide the greatest potential for productivity improvement, since the rewards are tied to individual performance and are frequently made (each paycheck). However, in many circumstances, especially for white collar workers, lack of a clearly measurable output makes such plans infeasible. Questions of quantity vs. quality may be raised, even where tangible output exists. Finally, there are well known problems with the dynamics of standard setting, especially the (perverse) incentives created for workers to restrict output in order to keep norms low.

Simple incentive plans do not receive favored tax treatment since incentive pay is taxed as current income. From an economic perspective, this treatment is reasonable. If these plans do improve firm performance, they are likely to be adopted without tax preferences. In the Weitzman view, simple incentives do not foster external macroeconomic benefits. Without such social externalities, tax preferences are unwarranted.

<u>Gain sharing plans</u> in contrast, because they are often based on value added or sales, may yield Weitzman-type benefits. (Whether they do or not depends on the bonus formula used). Like simple incentives, gain sharing receives no preferred tax

treatment. Gain sharing systems generally involve bonuses based on labor cost savings at the plant or firm level. Because these programs are group oriented, they are viewed by proponents as devices to improve teamwork and general job satisfaction. The formulas used to determine gain sharing bonuses are complex.

Employee stock ownership plans involve creation of a trust which holds company stock for employees. ESOPs have received increasingly favorable tax treatment since the mid 1970s on the theory that they spread wealth and turn workers into mini-capitalists. However, the plans do not produce Weitzman-type external macro benefits.[2] In principle, ESOPs can be used to provide a vehicle for 100% worker ownership. Such ESOPs are rare, but often well publicized.

Tax credit ESOPs (TC-ESOPs) -- most recently known as PAYSOPs -- enjoyed an implicit tax subsidy which exceeded 100% of their cost![3] The amount of employer "contribution" permitted was quite limited. Revisions of the tax code in 1986 removed the tax subsidy for PAYSOPs.

Finally, profit sharing plans link bonuses to company profits. Those plans that pay cash bonuses receive no tax preferences. If the plan provides for deferred benefits, i.e., paying the bonus into a retirement fund, employee tax liability is deferred. However, the implicit tax subsidy is no greater than provided under qualified pension plans and deferred savings arrangements such as 401(k) programs. Yet if profit sharing plans offer the macroeconomic external benefits suggested by

Weitzman, they have the best claim on preferential tax treatment of any of the flexible pay systems.

II. SURVEYS OF PLAN USAGE.

Table 1 summarizes information from four major surveys which relate to flexible pay. Other data sources are also available, but there is no comprehensive survey providing detailed information on the number and characteristics of employers and employees involved in such pay systems, or on the employer expenditures involved.[4] Based on the limited data available, the following conclusions can be reached.

Incentive plans still are used with some frequency, especially in situations where output is easily measured. However, they appear to have declined in popularity over the long run and in recent years.[5] Gain sharing plans are so rare that they must be regarded as curiosities. Profit sharing plans cover no more than a fifth of private employees.

Data on employee stock ownership can be misleading. Most of the workers covered by such plans had TC-ESOPs, not "regular" ESOPs. TC-ESOPs were likely to be found at larger firms where personnel managers understood that the U.S. government was paying for them. With the tax subsidy now removed for TC-ESOPs, more attention will be focused on regular ESOPs (which cover only a small proportion of workers). Regular ESOPs enjoy a considerable tax subsidy, especially when used as financing tools.

III. MANAGEMENT ATTITUDES.

A recent survey of private sector management attitudes

Table 1

Flexible Compensation Plans: Major Data Sources

1) Bureau of National Affairs, Basic Patterns in Union Contracts, triennial survey of 400 union contracts. Reports one third of contracts have simple incentives, concentrated in manufacturing.

2) Bureau of National Affairs, Productivity Improvement Programs, 1984 survey of 195 employers. 19% have profit sharing, 18% have employee stock ownership, 1% have Scanlon, 1% have Improshare, 40% have performance bonuses, 10% have piecework.

3) General Accounting Office, Employee Stock Ownership Plans, special survey of 4,200 ESOPs and TC-ESOPs based on IRS reports covering 7 million workers as of 1983. 90% of these employees are under TC-ESOPs.

4) Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms. Annual survey covering over 42,000 establishments with 23.1 million workers. In 1985, 18% of covered workers had profit sharing, 2% had ESOPs, 22% had TC-ESOPs.

Table 2

Characterization of Flexible Compensation Plans by Survey Respondents

	Profit Sharing	ESOP	Tax Credit ESOP	Gain Sharing	Simple Incentive
Best for:					
Raising productivity	28%	5%	*	26%	41%
Increasing loyalty	48	17	2%	19	14
Providing for retirement income	80[1]	13	7	n.a.	n.a.
Linking labor costs to firm performance	53	n.a.	n.a.	28	19
Easiest to:					
Explain to employees	32	9	7	4	49
Administer	40	7	12	4	38

n.a.=not asked.
*Less than .5%.
[1]Refers to tax-deferred profit sharing plans.

Based on 508 surveys returned as of October 15, 1986 from personnel/IR managers.

toward flexible pay systems for nonexempt employees was conducted by the authors.[6] Personnel/IR managers were asked about the use of such systems in their firm and about their views of such plans (regardless of use). The survey produced a wealth of data which can only be highlighted in this report.

Management attitudes toward flexible pay are summarized on Table 2. Generally, the respondents believed that of the five flexible pay systems listed on the table, simple incentives were the best productivity enhancers and were the easiest to explain to workers. Profit sharing was seen as providing flexible labor costs to the firm, increasing loyalty, and (in the deferred form) providing a useful retirement program. Gain sharing was viewed as more complex to administer and explain than the other plans, but as having a beneficial effect with regard to productivity, loyalty, and labor cost flexibility.

TC-ESOPs were not highly rated. Undoubtedly, part of the reason is the extremely limited employer "contribution" that was permitted by Congress for these plans. However, regular ESOPs also do not show up well in the relative rankings of Table 2. Proponents, of course, can cite numerous case studies in which benefits did accrue from the use of ESOPs. And the purpose of this essay is not to dispute those findings. The issue is rather one of alternatives, particularly since Congress has focused its favors on the ESOP and its variants.

It might be noted in this connection that about one fourth of the sample respondents were employed by firms with ESOPs. Yet they were not significantly more likely to rank the ESOP approach as best with regard to productivity and loyalty. ESOP users were more positive than others about the use of ESOPs for retirement savings and to their ease of administration and explanation. But they still rated other plans as better on these dimensions.

IV. THE QUESTION OF SUBSTITUTABILITY.

In principle, employers can have a mix of flexible compensation systems; having one plan does not necessarily preclude also having another. But employers might not chose to mix the plans if they believed that one was sufficient to meet their objectives. Based on the survey it is possible to ask two questions: 1) What does management <u>believe</u> about the substitutability or complementarity of flexible pay plans? 2) What does management <u>do</u> with regard to mixing such plans?

Table 3 reports on findings related to attitudes (as opposed to practices). Respondents were asked whether they agreed or disagreed with the proposition that having one type of specified plan made it unnecessary to have some other specified plan. It is most useful to concentrate on the findings with regard to profit sharing, ESOPs, and simple incentives, since TC-ESOPs have lost their tax preferences and gain sharing is so rare.

Obviously, there are some managers who feel that having an ESOP precludes having profit sharing. This view is stronger among those who have ESOPs than among others. But even among ESOP users, only one fifth take this position. About a sixth of the managers in firms with simple incentives believe that such

Table 3

Management Attitudes Concerning Plan Substitutability

Percentage of Respondents Generally or Strongly Agreeing that Having One Plan Obviates Need for the Other

Firm doesn't need --> / if it has:	Profit Sharing: Cash Bonus	Profit Sharing: Tax Deferred	ESOP	Tax Credit ESOP	Gain Sharing
Profit sharing					
Cash bonus	-	n.a.			
Tax deferred	n.a.	-			
ESOP	16 (20)	15 (19)	-		
Tax credit ESOP	13 (6)	12 (4)	23 (23)	-	
Gain sharing	28 (43)	23 (27)	13 (6)	9 (10)	-
Simple incentive	17 (17)	14 (14)	5 (2)	5 (4)	24 (24)

n.a. = not asked.
Based on 508 surveys returned as of October 15, 1986. Percentages refer only to those answering the question. Figures in parentheses refer to respondents whose firms had the plan applicable to the table row.

Table 4

Effect of Having Alternative Plans on Incidence of Profit Sharing and ESOPs

Type of Respondent:	Profit Sharing: Have Plan	Profit Sharing: Do Not Have Plan	ESOP: Have Plan	ESOP: Do Not Have Plan
All Respondents	52%	48%	25%	75%
With ESOP	54	46	-	-
With profit sharing	-	-	25	75
With tax credit ESOP	48	52	33*	67*
With gain sharing	48	52	16	84
With simple incentive	58	42	28	72

*Significant difference indicated by Chi-squared test between those with and without tax credit ESOPs. (Chi-squared = 11.658).

Based on 508 surveys returned by October 15, 1986.

incentives obviate the need for profit sharing. No relationship is seen between ESOPs and simple incentives. Stated attitudes, in short, are not barriers to adopting more than one plan.

Information on actual practice is presented on Table 4. The table shows the proportions of respondents who report their firms have (or do not have) profit sharing plans and ESOPs. Partly because of the sample design, and partly because of response bias, the proportions having profit sharing and/or ESOPs are much higher in the sample than in the general population (as discussed in Section II above). About half of the respondents report having profit sharing programs and about one fourth have ESOPs.

Generally, having another flexible pay system does not have a statistically significant effect on the chance that the respondents' firms also had profit sharing or ESOPs. The only significant association reported is that those with TC-ESOPs were more likely also to have regular ESOPs. Presumably, knowledge of operating one type of plan was helpful in operating the other.

V. PUBLIC POLICY IMPLICATIONS.

Of course, there is another kind of substitution possibility which is not reflected in the survey. Congress has made certain choices in targeting its tax expenditures in the flexible pay area. Specifically, with the 1986 tax law revisions, it has chosen to favor ESOPs over all other arrangements.

In the past, this preference was attributed by many observers to the influence of Senator Russell Long. With Long's retirement, however, it is unclear why this preference--

particulary for ESOPs over profit sharing -- should continue. Based on the analysis of Weitzman and others, it is profit sharing which has the greater claim for a social subsidy due to its potential macroeconomic benefits.

VI. CONCLUSIONS.

The title of this paper asked who has flexible compensation and why aren't there more of them. Within the (severe) limits imposed by data availability, the first question has already been answered. As to the second, the following responses can be given.

Simple incentives exist where output can be measured and where firms believe they can overcome some of the administrative and perverse incentive problems such programs entail. Gain sharing is perceived to be difficult to explain and administer (compared with other plans), so its use is extremely limited. TC-ESOPs existed only because of extreme Congressional beneficence. Regular ESOPs seem also to depend on Congressional favoritism; even so, they are not very widespread.

Finally, profit sharing is seen as inferior to simple incentives if the objective is just to raise productivity. But it receives good overall ratings from managers and can be (and is) used in conjunction with incentives. Recently, profit sharing has made inroads into the unionized sector of the economy in autos, steel, telephone communications, and lumber. If Congress chose to reorder its preferences, use of profit sharing could be extended.

FOOTNOTES

1. Martin L. Weitzman, The Share Economy: Conquering Stagflation (Cambridge, Mass.: Harvard University Press, 1984).

2. This issue cannot be explored here. Essentially, the problem with ESOPs is that employees take their benefits with them when they leave the firm (in the form of shares or a cash payment for their shares). Under profit sharing, however, departing employees receive either nothing or -- under deferred plans-- their past bonuses. See Daniel J.B. Mitchell, "The Share Economy and Industrial Relations: Implications of the Weitzman Proposal," Industrial Relations, forthcoming.

3. U.S. Office of Management and Budget, Special Analyses: Budget of the United States Government, Fiscal Year 1987 (Washington: GPO, 1986), pp. G29-G30.

4. Interested readers may wish to refer to publications of The ESOP Association, the Profit Sharing Council of America, the Profit Sharing Research Foundation, the National Center for Employee Ownership, and the U.S. Chamber of Commerce for examples of available information.

5. Norma W. Carlson, "Time Rates Tighten Their Grip on Manufacturing Industries," Monthly Labor Review, vol. 105 (May 1982), pp. 15-22.

6. The survey consisted of a mail questionnaire sent to personnel/IR managers whose names appeared on mailing lists of the UCLA Institute of Industrial Relations, the IRRA, the Internal Revenue Service, and the American Compensation Association. Information about this survey can be obtained from the authors and will appear in other forums.