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## Re-evaluating the Relevance of Service Related Pay in a 21<sup>st</sup> Century Context

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### **Abstract:**

*The aim of this paper is to critically evaluate the notion of 'Service Related Pay' (SRP) as one facet of the overarching contingent pay structure, by examining the benefits, shortfalls and issues pertaining to equity in the use of SRP in 21<sup>st</sup> century organisations. This paper examined theoretical perspectives underpinning the notion of Service Related Pay, it is based on the review of existing literature on service related pay within organisations in different countries. It also examined the implications of service related pay, paying particular attention as to how alternative forms of contingent pay, such as performance based pay can overcome the tensions highlighted and concludes by discussing the advantages and implications of performance related pay as a workable solution to the shortfalls in utilising service related pay (SRP) as a reward management strategy.*

*This paper is relevant because majority of service related pay studies that have been conducted within developed and developing countries authenticate the operational issues of successfully introducing major pay reforms and suggest somewhat limited effectiveness. It is hoped that the outcome of this paper will provide relevant and valuable lessons for reward policy-makers in both developed and developing countries as they implement reward reforms within their organisations.*

**Keywords:** *Service related pay, performance related pay, developing and developed countries*

### **1. Introduction**

The type of reward offered to employees is important in attracting and retaining the right individuals that will help the organisation to achieve its goals. As ACAS states, 'The level and distribution of pay and benefits can have a considerable effect on the efficiency of any organisation, and on the morale and productivity of the workforce' (2012). The type of pay chosen by organisations will therefore be influential in its running and should be considered carefully. The term contingent pay can be broadly defined as 'base pay increases that are contingent on the results people achieve' (Armstrong & Cummins 2011 p.133) or alternatively, as the result of an individual displaying the right behaviours or results befitting the needs of an organisation (Brumback, 1988). In essence, contingent pay seeks to differentiate between employees who exhibit traits that are desirable by the organisation, such as loyalty, performance, profitability, and those who do not (Pendleton et al, 2009).

Historically, pay structures in large public sector and manufacturing organisations were determined by collective bargaining, with trade unions setting out the financial demands of the workforce as a single entity (Kessler, 1995). Indeed, there is a clear history of union opposition to contingent pay (White and Druker, 2000). Research by Heery and Walhurst (1994) states that trade unions highlight contingent pays as having the potential to demotivate the workforce and erode teamwork by replacing cost of living increases with arbitrary, often performance related targets. However, contingent pay has become increasingly used as a means to regulate pay with the decline in trade unions since the latter end of the 20<sup>th</sup> Century (Brown et al., 2009). For, almost simultaneous with the trade union decline since the 1970s, the concept of contingent pay became more and more widely used by organisations looking to encourage high productivity, manage and reduce fixed salary costs and enable greater pay flexibility (Perkins and White, 2011). The aim of this paper is to critically evaluate the notion of 'Service Related Pay' (SRP) as one facet of the overarching contingent pay structure, by examining the benefits shortfalls and issues pertaining to equity in the use of SRP in 21<sup>st</sup> century organisations. This paper examined theoretical perspectives underpinning the notion of Service Related Pay, it is based on the review of existing literature on service related pay within organisations in different countries. It also examined the implications of service related pay, paying particular attention as to how alternative forms of contingent pay, such as performance based pay can overcome the tensions highlighted and concludes by discussing the advantages and implications of performance related pay as a workable solution to the shortfalls in utilising service related pay (SRP) as a reward management strategy. It is hoped that the outcome of this paper will provide relevant and valuable lessons for reward policy-makers in both developed and developing countries as they implement reward reforms within their organisations.

## 2. Literature Review

The broad nature of contingent pay as a concept poses a challenge for organisations looking to introduce a new reward strategy. Research by Chiang and Birch (2011) suggests that the type of contingent pay strategy adopted by an organisation depends on contextual factors such as performance values, preferences and desired behaviours. In short, the choice of contingent approach chosen by an organisation is defined by both the overall strategic aim of the organisation; be it profitability or service related, or even determined by the country in which the organisation is based.

SRP, then, is merely one element of the multi-strand concept of contingent pay, and defined by Armstrong and Murlis as ‘the traditional form of contingent pay’ (2007, p.320) widely used by public sector and unionised organisations. In its simplest form, SRP refers to a system of increments paid to individuals who have achieved length of service milestones in a certain role or job grade (Armstrong, 2012). It is based on the overall notion that length of service equates to wisdom and experience, which in turn leads to increased effectiveness in a particular job role that is then rewarded with, in most cases, increased remuneration. Usually paid on an annual basis and very rarely held back for reasons of absence of underperformance, this is the form of contingent pay most favoured by trade unions as it is perceived as being universal, and not pertaining to a particular skill or over performance (Armstrong & Stephens, 2005). Notably, this method of contingent pay has been all but eradicated in the private sector, which is indicative of its lack of ability to encourage increased performance or profitability.

SRP is intended as a reward management scheme that exhibits both fairness and universality; for as an individual spends increasing lengths of time in a role or within an organisation, their level of basic pay increases incrementally regardless of skill, ability or background. Indeed, organisations who practice this reward strategy win wide-spread admiration from industrial trade unions for its universal approach. Nonetheless, there is a compelling contrasting argument which stipulates that pay differentials in the workplace relating to service, rather than promoting equity and comparison, in fact conjure manifestations of demotivation and injustice in the workforce (Bloom, 1993). In such cases, employees have been known to cite feelings of disillusionment and a lack of group dynamics (Pfeffer & Davis-Blake, 1992) linked to an overall lack of *un*-fairness with regards to their remuneration. Pfeffer & Langton (1993) thus link this ‘*un*-fairness’ to the lack of perceived recognition for output. Often, employees who are new to the organisation lose commitment and enthusiasm for their role having witnessed the sense of entitlement experienced by their aging colleagues who are theoretically being paid a greater salary for the same work and same output by virtue of their longevity within the business only. Or, in the words of Perkins & White (2011) those who are contributing the most to the organisation are not being fairly and equitably rewarded. It can be argued, therefore, that the notion of SRP causes an inequality linked to age – for the younger members of the workforce will always be paid less than their time-serving counterparts. Indeed, recent studies by Lyons et al (2010) and Jin & Rounds (2012) have suggested that the younger generation, notably the Millennial workforce, place less importance on structured, tangible financial increases which are inherent in the SRP concept suggesting a preference for a recognition based system of pay.

The inequalities intrinsic to SRP sector spread too to the notion of gender. Holzer (1990) argues that there is a significant statistical relationship between years served in a business, and the salary paid by the business to these time serving individuals. Fitzgerald (1998) explains this with a link to authority – in that length of time spend with a business naturally means that time-serving employees experience a ‘pay drift’ into roles of greater authority and thus greater remuneration. It is this link to authority that provides a clear insight to the pay disparities between men and women in organisations who adopt a SRP scheme. It is well documented in literature that female employees are less likely to obtain positions of authority than their male equivalents in the workplace (Jacobs, 1992; McGuire & Reskin, 1993) and it is therefore logical to assume that women, who traditionally take time out of the workplace for a period of maternity leave, or a longer period to raise children, suffer in institutions that introduce or practice SRP schemes as a method of stabilising remuneration. Indeed, Trommer (1995) supports this view, in stating that it is statistically proven that that women who stay with a single employer for longer periods of time, without breaks in employment, do experience greater enhancement of salary packages.

### 2.1. Equity Tensions

One of the main criticisms is the inequality created by service related pay. The inequality can be seen to be evident in a number of areas:

#### 2.1.1. Gender

It is argued that one of the downfalls of service related pay is that it is detrimental to women who have taken time out of work to have children. Men who have worked constantly have been able to take advantage of the consistent rise in their increments and therefore salary, whereas women have been forced to sit on a lower pay point when returning to work after a break. ‘Extended pay ranges, especially where progression is based on length of service, will favour men, who are much less likely than women to have career breaks and may therefore progress further and faster’ (Armstrong 2012:249). Although they may be performing the same role and inputting the same amount of effort, women may find themselves receiving a lower salary. As stated, ‘women progress more slowly through salary scales and seldom reach higher points, while men are consistently appointed at higher points on a salary scale than women’ (Morrell et al. in Rowbottom 2010).

#### 2.1.2. Performance

It has been argued that unfairness exists because the salary does not consider individual performance levels. Tensions may arise between employees who can see others with longer service, and therefore on a higher salary, performing less, whilst others on a lower

salary are high performers. This unfairness is highlighted by Armstrong, who argues that it 'pays people simply for being there and this could be regarded as inequitable in that rewards take no account of relative levels of performance' (2012:272).

### 2.1.3. Senior v Lower Level

Service related pay can be seen to create a hierarchy where those performing the same job are seen as inferior by those that have been at the organisation longer and therefore known to be on a higher salary. Those on a higher salary may be threatened by the performance of the newer employees and may be less likely to share information with them. This can also be linked to age discrimination as older employees take the higher incremental level because they have been with the organisation longer; therefore, a 'possibility of unlawful age-based discrimination' exists (Shields 2007:250). These inequalities can create dissatisfaction for employees and sits with Adams' Equity Theory where individuals compare their own treatment to that of others based on the inputs, or contribution, they have made compared to the outcomes, or rewards, that they have received as a result. This is discussed by Mullins who states 'According to equity theory, people place a weighting on these various inputs and outputs according to how they perceive their importance. When there is an unequal comparison of ratios the person experiences a sense of inequality' (2010:275).

It is therefore clear from the literature surrounding the subject of SRP as a contingent pay strategy does, in the words of Perkins and White, raise the issue of equity around employee reward (2011). The following section of this paper will examine these issues in practice.

### **3. Methods Section**

This paper is based on the review of existing literature and document analysis of case-study evidence on service related pay within organisations. Secondary data collection was utilized in gathering data for this article. Case-studies of previous studies undertaken within organizations in the field of service related pay across different continents. This consisted of primary data and information which was collected in the previous studies of other researchers. The data and information collected is well-supported by the documentations and explanations. The analysis of the documents and case-studies was achieved using thematic analysis, which is a method for identifying, analysing and reporting patterns (themes) within data (Braun and Clark, 2006). This method minimally organizes and describes data set in (rich) detail. It however goes further than this to interpret various aspects of the research topic (Boyatzis, 1998). Through its theoretical freedom, it can provide a rich and detailed yet complex account of data (Braun & Clarke, 2006).

### **4. Analysis & Discussion**

One of the most basic and fundamental flaws with the system of SRP in practice is the lack of recognition based on the contribution to the organisation, or to the role. This is because an employee will continue to receive increased reward regardless of their contribution to the overall success of the organisation. This section of the report will discuss the practical implications of SRP in the UK public sector before examining the tensions inherent in SRP in other countries and cultures.

As discussed, SRP is the historical favourite of the UK trade unions in that it does not differentiate skill set and instead rewards loyalty – a transient element of the employer/employee relationship that can be exhibited by any individual regardless of educational or experience background. This means that each workforce member can equitably and continuously compare themselves to the next and feel they are being treated favourably, underpinned by Adams' equity theory (1963). In the UK SRP is associated in the foremost with public sector organisations such as the NHS and the Civil Service, both of which are heavily unionised and have not experienced the same downturn in trade union activity experienced by other sectors, such as manufacturing. In the late 1980's and early 1990's, Civil Service employees in the UK were remunerated based on their nominated groupings, such as 'Tax Inspectors', 'Clerical and Secretarial', 'Executive', and each grouping negotiated their SRP increments via a system of collective bargaining. However, this was shown to be yielding a pay-drift culture, with new graduates and younger talent feeling deterred from a public sector career by the long-distant road to the upper echelons of the pay structure. In order to combat this drift and encourage new talent into the sector with greater output, in 1992 – 1993 SRP began to disappear and performance related pay was introduced into a number of Civil Service departments for the first time (OCDE, 1996). This reform continues over a decade later, with the latest guidance on Civil Service Pay stating that any remaining Government departments with progression pay scales still in place by the end of 2016, they will be in breach of government policy (UK Government, 2015).

Service related pay in the UK has shown little to no impact on productivity or performance of public sector organisations (Williams, 2009). With the economic recession causing increased spotlight on government expenditure and on public sector pay in particular, the UK government has been forced to place emphasis on pay reform (Chan, 1999) and productivity (Burgess *et al*, 2011) over long service and loyalty, to align with large private sector organisations who place value on performance in the first instance. This, coupled with the end of the 'job for life' culture in the UK, with projections by the CIPD estimating that of young people entering the job market for the first time, only 1.5% will retain a single job for their entire working lives (CIPD, 2014), suggests that the very notion of SRP is reaching an obsolete phase – for, if loyalty to an organisation is no longer a practical option in the 21<sup>st</sup> Century, then SRP as a concept is no longer valid.

This strategic direction differs greatly, however, from pay strategy in some Asian countries such as Korea and Japan. The move away from service related pay can be met with enthusiasm in some instances where benefits of, for example, one-off bonuses, make a marked and measurable improvement in efficiency. This was evident in the health care service in Rwanda, where the implementation of output based bonuses for performance in 15 health centres was a success and resulted in a dramatic increase in staff productivity.

(Meessen et al. in Maycock and Puplampu 2014) The potential attainment of bonuses on performance here offering a higher incentive than that of service related pay. A country with a high use of service related pay is Japan where it is a popular system for many employees. There has though, been an attempt to move away from service related pay because of some of the inefficiencies with its use, a move which has caused mixed reactions. A study discussed by Peltokorpi (2011) describes an attempt to move away from service related pay by a company who found that their Japanese employees on high salaries, because of length of service, were not performing particularly well and their roles could possibly have been filled at a lower cost by individuals with less service but with more enthusiasm for the work. It was seen that there was a sense that when the employees reached a certain age and management position, they felt that they did not have to work as much as others (Peltokorpi 2011). A sense of entitlement could therefore be seen to be evident.

Korean firms value loyalty and commitment to an organisation over any other employee attribute (Chang and Hong, 2000), which is reflective of the cultural values that underpin the Korean nation as a whole. In a study of 500 Korean government office workers it was found that Korean local government and public sector maintained service related pay and employed a job for life culture in order to retain the loyalty and engagement of every employee (Kim and Kim, 2003) and to ensure that talent is retained by the organisation. Even with the East-Asian economic downturn in 1997, the Korean government departments continued to employ a system of SRP in the most part, despite vast swaths of criticism from their western counterparts who had begun to move to performance related pay schemes in light of the changing world financial market, such as can be seen in the UK Civil Service. However, for Korean organisations performance-related pay is often considered to be a deviation from the traditional model of SRP that reflects the cultural values of loyalty and long service, and as such any change to the reward system is regarded negatively both by the organisation, and by the workforce (Boxall and Purcell, 2003; Whitley, 1999). Furthermore, such changes placing unwelcome focus on the merits of the individual workers as opposed to the collective workforce, and can be perceived to threaten said cultural values. However, in the 21<sup>st</sup> Century, the Korean public sector is beginning to see performance related pay as burgeoning answer to the inequity and unsustainability of SRP in their country in the wake of financial instability (Kho *et al.*, 2008), despite strong resistance from unions (Kang & Yanadori, 2011). This is shown through the number of Korean organisations moving towards performance related pay schemes in the early 21<sup>st</sup> century, though this is still behind the UK and other European organisations who have more readily adopted the performance related pay schemes. As stated 'Economists say the removal of seniority pay will increase work incentives for employees and spur movement of people across sectors'. (Financial Times 2015) Companies including Toyota, Hitachi and Panasonic are all reported as making the move with Hitachi reported as stopping service related pay for 11,000 of their employees above a certain grade so that the salaries are based on their responsibilities and performance and not length of service (The Japan Times 2014). As in the study discussed by Peltokorpi, there has been a resistance by some Japanese employees to move away from their familiar service related pay, stating 'cultural incongruence was the primary reason for low acceptance of PRRS by Japanese employees' and that 'the strong resilience of seniority – based reward systems can be explained partly by their linkage with the cultural values of respect for seniority and group orientation' (Peltokorpi 2011). In the case discussed in this study, the company decided to return to service related pay after a trial period of performance related pay because of an increase in employees leaving.

The shift from seniority related pay in the public sector both in the UK and Korea, whilst taking place at different rates, is underpinned by the desire to move to a more productive and performance orientated output and reduce inequalities inherent in the scheme, such as the demotivation of young talent and encourage greater workforce drive. The different pay systems companies chose can be seen to follow the different values that are important to employees in the countries in which they operate; this can lead to preferences and a prevalence of certain systems. As stated, 'In the United States, pay is mainly job based, while in Japan, family size and seniority pay tend to play a bigger role. In Germany and Australia, compensation for many workers is centrally determined through collective bargaining and government tribunals' (Ozeki 2000). Research by Bart et al (2012) supports this view, in that when measuring output statistics of organisations with performance related pay versus fixed rate seniority related pay in a selection of public sector organisations in Norway, they found that those organisations that employed a performance related strategy saw a statistically significant increase in output. The positive implications of PRP, such as attracting goal orientated and ambitious talent (Cable and Judge, 1994), driving individual workers to succeed (Jenkins et al., 1998), and organisational performance are further emphasised with the shift from SRP and increased competition from private sector organisations (Horton, 2006).

Performance related pay (PRP) as a concept redefines the binaries of equity, and in keeping with Adams' equity theory (1963) still allows for a comparison between individuals within an organisation, but will also encourage employees to perform better as they can see the link between their efforts and reward (Vroom, 1964) and as such pay becomes a motivator, as opposed to an entitlement as under SRP. Defined as the connecting force between financial remuneration and the achievement of targeted objectives (Armstrong & Brown, 2009), PRP also allows for the reduction in discrimination in terms of age and gender by levelling the terms between employees and rewarding based on individual output. PRP, as opposed to SRP also re-determines psychological contract between the employer and employee, in that performance becomes intrinsic to the job itself.

Performance related pay is therefore recommended as an alternative to SRP in organisations that are looking to improve the output of their workforce, but organisations should be mindful of the shift in culture that will ensue. Armstrong (2002) asks a number fundamental questions before PRP is introduced to an organisation, in particular if good performance in itself can be identified and if this can be one fairly and consistently. For the public sector, this can be more difficult when output is measured in service rather than numerical product which is often the case in the private sector. Furthermore, this can provide additional challenges for line managers who are required to deduce the nature of 'good' performance and make judgements on the success or otherwise of individual employees which directly affect their remuneration. However, in a study of OECD government organisations where two thirds of

member countries had made the transition from SRP to PRP they had seen increased output and increased workforce engagement through staff surveys that has been measurable on the previous SRP system (OECD, 2005).

## 5. Conclusions

For the 21<sup>st</sup> Century organisation, it is clear that SRP no longer meets the needs of the post-recession workforce for whom a 'Job for Life' is more myth than reality. SRP is therefore an increasingly outdated concept, favoured by dwindling trade unions and previously by public sector organisations for whom change, too, has become a necessity in the modern world. There is a clear need for a more flexible and more accountable method of reward in the 21<sup>st</sup> Century, with financial crashes across Europe and Asia forcing previously traditional cultures such as Korea to re-examine their priorities and introduce PRP into the public sector. It is important for organisations to be mindful of equity and cultural shift when introducing PRP (Armstrong, 2002). Equally, it is apparent that introducing PRP can have a positive impact not only on performance but also on workforce engagement.

Nonetheless, whilst the benefits of PRP are tangible and well documented, it is important to legislate in new HRM policies to mitigate as far as is possible for the challenges to line managers who will be required to determine salary-related successes where previously this would be determined by an overarching service related structure over which they had no influence. Furthermore, the design of any PRP scheme should be conducted with the question of equity in mind and should be clear as to not discriminate against age, gender or any other protected characteristic, and also set clear boundaries for mitigating any un-ethical behaviours. The following recommendations are intended to provide guidance on the introduction and management of a PRP strategy in the long term.

## 6. Recommendations

The following recommendations set forth an overview of the introduction of PRP as an alternative to SRP in the public sector, and the ways in which the monitoring and evaluation of this new Contingent pay scheme will take place in both the short and long term.

1. Design and Implementation – in the short term, is imperative that in the design and implementation phase, thought is given to the definition of 'performance' and how 'good' performance is to be distinguished from 'poor' performance in each instance. At the implementation phase both employees and line managers, and trade unions if and where applicable, should be involved in the design process to ensure buy in and long term success.
2. Guidance and Training – Line Management should be given appropriate training and guidance material to ensure the system is appropriately managed and understood. Employees should also be given the opportunity to ask questions and challenge aspects of the scheme through employee forums.
3. Trial Period – the new PRP scheme should be introduced on a trial basis. In multi – layered organisations, it may be prudent to introduce the scheme at a management level in the first instance to ascertain effectiveness, before rolling out to the overall workforce. Furthermore, once the scheme is in place review periods should be set at 3 months, 6 months, 1 year, and 2 years to ensure that the scheme is being applied fairly and consistently across the organisation.
4. Long-Term observation – review of the scheme should take place on an ongoing basis in the short term, with spot questionnaires of employees and managers as well as statistical analysis of performance output pre-and post-move from SRP to PRP to assess effectiveness. In the long term, annual employee surveys should take place to determine engagement levels.
5. Ongoing reward of Long-Service – It is important to remember that organisations that previously adopted an SRP scheme fostered a culture of long service and loyalty, which should continue to be recognised. It is therefore recommended for organisations to launch an alternative method of reward for long service milestones, such as additional annual leave or one-off bonus payments to ensure a smoother transition to PRP.
6. Change Management - PRP should not be introduced in isolation. This is an opportunity to introduce a wider cultural shift in an organisation in the long term, therefore the opportunity exists for the business to adapt by introducing structure around appraisals, career ladders and clarification of job roles and skills.

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