

## **Incentive System**

The Performance Incentive System is considered critical to the successful operation of the PC system. The PC system is an elaborate exercise which sets out performance targets and provides for an equally elaborate system of evaluation. All these would be meaningless, if not fruitless, unless the efforts of those who strive hard to fulfil the provisions in the contract are recognised and given some kind of special remuneration. The incentive system provides motivation for both the executives of the enterprise and the workers.

### **Legal Hurdles**

In operating an incentive system, the first hurdle to clear is the legal provisions of the country as they affect the incentives, such as bonuses distributed to employees. In several countries, there are laws which permit the workers to take up collective bargaining in order to get a proper share of the surpluses generated by the company. Several decades of collective unionism have entrenched the practice in such countries among the management and workers alike. The workers are very reluctant to give this up; they expect that the minimum guaranteed incentives which come from the PC system to be treated as a deferred wage which is paid because they have achieved certain, and maybe "special", targets. The surplus to be shared by them has to be negotiated and this right cannot be taken away from them. In India, for example, prizes are distributed to those PEs which have excelled during the reporting year; no monetary rewards are given. In The Gambia, the incentive system includes monetary awards.

In countries where there are no legal hurdles, the incentive system has been installed as part of the PC system without any complications. Since monetary incentives require large financial resources, it is important that the performance evaluation, which is the basis for such an award, be transparently efficient. Otherwise, the incentives may become a de-motivating factor, especially for those PEs which have striven hard and have achieved better results but were not properly evaluated. The most important aspect of designing an incentives system is that it should be based on an effective evaluation system which is understood by all the PEs involved in the PC system.

### **BOX 6.1: The Incentive System in Ghana**

Performance contracts negotiated in 1989 and in subsequent years provide for bonuses to be paid to all employees of the enterprise, both management and workers. This practice differs from that in other countries where a performance contract defines the criteria for payment of incentives or bonuses to managers. The incentive bonus referred to in current performance contracts is generally assumed by enterprise management to correspond to the provision in many collective agreements for payment of an annual bonus to all employees. The distribution rules followed in most SOEs mean that all employees in qualifying enterprises receive an annual bonus of approximately 10 per cent to 15 per cent of their salary.

*Source: W.A. Adda, op. cit., p.7*

#### **Type of Incentives**

An incentive system may be pecuniary or non-pecuniary or both. Some countries attach great importance to certain titles conferred by the government, e.g. Malaysia. In some countries the executives may be motivated more by non-pecuniary rewards (i.e. titles), whereas the workers may opt for a pecuniary reward.

#### **Key Issues**

It must be emphasised that for an incentive system to be effective, it should be transparent and well understood by all the parties to the contract so that, right from the time the contract is signed, the parties will be motivated not only to achieve the targets but also to achieve the extra levels of performance which will earn the bonus. Unless the incentive system is clear to all, there will be disagreements which may adversely affect the operations of the entire system.

Another issue that should be noted is the imposition of penalty for non-achievement of performance. There is the view that penalties should be the other side of the coin of incentives. Penalties such as stoppage of increment and a small cut in salary for the succeeding year may be included in the contract. But there is another view that, until the PC system is well established, the imposition of penalties for non-achievement of *targets* may lead to suspicion among workers and executives who feel that these have been brought in to punish them. This perception may reduce the acceptability of the PC system. Others have argued that the non-receipt of a reward can itself serve as a penalty. The fact that other enterprises in the same position and in the same industry are able to get rewards in terms of bonuses or titles for the executives, may be an active motivating factor. All this

points to one conclusion: that the incentive system deserves thorough discussion before a decision is taken on its introduction.

The next question is: Who are to be covered under the incentive system? In some countries, there is a history of executives not getting a monetary reward in terms of bonus. The award of monetary incentives in these countries may possibly lead to some kind of suspicion on the part of workers. The Indian situation is along these lines. However, there are countries where incentives have been given to executives as well as to workers. There are also cases where incentives are confined to a small team called a management team which takes responsibility for achieving the performance targets as contracted and to exceed those targets. This is the case in The Gambia, where the management team can earn as much as two years' salary as bonuses.

It would be useful, right from the beginning, to spell out who will receive a pecuniary benefit for achieving performance levels above the target and how the total bonus or reward will be shared by the executives and workers. Otherwise, each time a reward or bonus is announced, unnecessary industrial dispute may result. In some countries it may be necessary to enter into a separate contract with workers or their unions before the incentive provisions are included in the PC.

There are different views as to how much of a surplus should be used as a reward for executives and workers of the PE. Questions to be answered include: Can a bonus be given in loss-making enterprises? Should the amount distributed be linked with cash or profit generated?

It is important that the PC itself should specify clearly the extent of the surplus generated over and above the target level should qualify as reward to the workers and managers. In some countries, it has been accepted that one-third of the surplus generated should go to the workers, but there is a problem that in certain countries, rewards have been announced in terms of the number of months salary they would get as bonus for achieving different target levels. If a careful and thorough computation is not undertaken, the PE may end up paying bonuses out of the surpluses that should legitimately finance the operations of the PE.

There is also the question whether the company as a whole should get the rewards or just certain sections of it. An example would be an industry where there is very poor technological performance by way of conversion of raw material into the finished product. It may require a great deal of attention to the production machinery to see that the input/output ratio is significantly upgraded. Should there be a separate mention regarding incentives to be given to the people who work on this section if they make an extraordinary contribution to the achievement of targets? Similarly, in the case of certain enterprises, such as electric companies in developing countries, the performance of meter reading, billing and revenue

collection may be very poor, but this is attended to by a group of non-technical workers in the electricity companies. If one fixes a target for better revenue collection, can one say that technical workers who are engaged in this area of activity alone would receive the incentive? These are issues which cannot be resolved in general terms. They have to be carefully examined on a case by case basis and to be resolved before embarking on a system of incentives appropriate and acceptable to all.

As the PC system is also to cover loss-making units, it may cover the units which make cash losses. In such companies, even for their day-to-day performance, they have to get a subsidy or a loan from the government to cover the cash deficits each year. There are scores of industries under the central government which make cash losses. If the improvement of performance is specified in certain terms in the PC, and if the company's management and workers achieve the targets, and the company is still making a loss, who will pay for the bonus? This naturally has to be paid by the government which may have to build up a pool of resources from surpluses paid in by profit-making companies. The justification, according to one school of thought, is that the company deserves the bonuses for improving its performance and for achieving its targets, even though it is not in a position to pay out such bonuses because the company makes cash losses.

### **Concluding Notes**

Finally, a well-designed incentives system can lead to a situation where employees and the government take the PC system seriously. But the incentives system must be designed in such a way that it is acceptable to executives and workers alike, and the evaluation system is closely linked to the incentive system so as to ensure that the distribution of the surpluses by way of incentives is transparent and acceptable to all. Otherwise, the incentive system, instead of motivating employees may not only de-motivate them but also become a source of irritation and adversely affect the overall performance of the company.