103

EMPLOYEE PARTNERSHIP PAY AND EMPLOYER FLEXIBILITY: NEW MODELS FOR STIMULATING JOB CREATION AND PRODUCTIVITY

Y 4. SM 1:103-94

Employee Partnership Pay and Employ...

HEARING

BEFORE THE

SUBCOMMITTEE ON REGULATION, BUSINESS OPPORTUNITIES, AND TECHNOLOGY

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

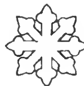
ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC, JULY 15, 1994

Printed for the use of the Committee on Small Business

Serial No. 103–94



U.S. GOVERNMENT PRINTING OFFICE

81–534 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046349-1

103

EMPLOYEE PARTNERSHIP PAY AND EMPLOYER FLEXIBILITY: NEW MODELS FOR STIMULATING JOB CREATION AND PRODUCTIVITY

Y 4. SM 1: 103-94

Employee Partnership Pay and Employ...

HEARING

BEFORE THE

SUBCOMMITTEE ON REGULATION, BUSINESS OPPORTUNITIES, AND TECHNOLOGY

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC, JULY 15, 1994

Printed for the use of the Committee on Small Business

Serial No. 103–94

U.S. GOVERNMENT PRINTING OFFICE

81–534 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046349-1

COMMITTEE ON SMALL BUSINESS

JOHN J. LAFALCE, New York, *Chairman*

NEAL SMITH, Iowa
IKE SKELTON, Missouri
ROMANO L. MAZZOLI, Kentucky
RON WYDEN, Oregon
NORMAN SISISKY, Virginia
JOHN CONYERS, JR., Michigan
JAMES H. BILBRAY, Nevada
KWEISI MFUME, Maryland
FLOYD H. FLAKE, New York
BILL SARPALIUS, Texas
GLENN POSHARD, Illinois
EVA M. CLAYTON, North Carolina
MARTIN T. MEEHAN, Massachusetts
PAT DANNER, Missouri
TED STRICKLAND, Ohio
NYDIA M. VELAZQUEZ, New York
CLEO FIELDS, Louisiana
MARJORIE MARGOLIES-MEZVINSKY, Pennsylvania
WALTER R. TUCKER III, California
RON KLINK, Pennsylvania
LUCILLE ROYBAL-ALLARD, California
EARL F. HILLIARD, Alabama
H. MARTIN LANCASTER, North Carolina
THOMAS H. ANDREWS, Maine
MAXINE WATERS, California
BENNIE G. THOMPSON, Mississippi

JAN MEYERS, Kansas
LARRY COMBEST, Texas
RICHARD H. BAKER, Louisiana
JOEL HEFLEY, Colorado
RONALD K. MACHTLEY, Rhode Island
JIM RAMSTAD, Minnesota
SAM JOHNSON, Texas
WILLIAM H. ZELIFF, JR., New Hampshire
MICHAEL A. "MAC" COLLINS, Georgia
SCOTT McINNIS, Colorado
MICHAEL HUFFINGTON, California
JAMES M. TALENT, Missouri
JOE KNOLLENBERG, Michigan
JAY DICKEY, Arkansas
JAY KIM, California
DONALD A. MANZULLO, Illinois
PETER G. TORKILDSEN, Massachusetts
ROB PORTMAN, Ohio

JEANNE M. ROSLANOWICK, *Staff Director*
JENNIFER LOON, *Minority Staff Director*

SUBCOMMITTEE ON REGULATION, BUSINESS OPPORTUNITIES, AND TECHNOLOGY

RON WYDEN, Oregon, *Chairman*

IKE SKELTON, Missouri
TED STRICKLAND, Ohio
NORMAN SISISKY, Virginia
JAMES H. BILBRAY, Nevada
MARTIN T. MEEHAN, Massachusetts
WALTER R. TUCKER III, California
THOMAS H. ANDREWS, Maine

LARRY COMBEST, Texas
SAM JOHNSON, Texas
JAY DICKEY, Arkansas
JAY KIM, California
PETER G. TORKILDSEN, Massachusetts
MICHAEL HUFFINGTON, California

STEVE JENNING, *Subcommittee Staff Director*
ROBERT LEHMAN, *Minority Subcommittee Professional Staff Member*

CONTENTS

Page

Hearings held on July 15, 1994 1

WITNESSES

FRIDAY, JULY 15, 1994

Kruse, Doug, associate professor of human relations, School of Management and Labor Relations, Rutgers University 31
McAdams, Jerry, director, Consortium of Alternative Reward Strategies, vice-president, Performance Improvement Resources, Maritz Inc., Fenton, Michigan 26
Mitchell, Daniel, John E. Anderson School of Management, UCLA, Los Angeles 36
Regian, Burnie W., Employee Involvement Facilitator, Oregon Steel Mills 7
Rezendes, Tommy, American Velvet Co., local president, Amalgamated Clothing and Textile Workers Union, AFL–CIO 12
Wenner, Paul, chief executive officer, Wholesome and Hearty Foods 5
Wimpfheimer, Jacques, president, American Velvet Co. 10
Wray, David, president, Profit Sharing Council of America 13
Zalusky, John, head of office of wages and industrial relation, AFL–CIO 33

APPENDIX

Opening statements:
- Wyden, Hon. Ron 46
- Combest, Hon. Larry 50

Prepared statements:
- Kruse, Doug 139
- McAdams, Jerry 95
  - Organizational Performance and Rewards, Executive Summary 100
- Mitchell, Daniel 167
- Regian, Burnie W. 59
- Rezendes, Tommy 79
- Wenner, Paul 51
- Wimpfheimer, Jacques 62
- Wray, David 83
- Zalusky, John 157

EMPLOYEE PARTNERSHIP PAY AND EMPLOYER FLEXIBILITY: NEW MODELS FOR STIMULATING JOB CREATION AND PRODUCTIVITY

FRIDAY, JULY 15, 1994

House of Representatives,
Subcommittee on Regulation, Business
Opportunities, and Technology,
Committee on Small Business,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359–A, Rayburn House Office Building, Hon. Ron Wyden (chairman of the subcommittee) presiding.

Chairman Wyden. The subcommittee will come to order.

Today the Small Business Subcommittee on Regulation, Business Opportunities and Technology begins a series of hearings to explore new opportunities for enhancing small business productivity. We are turning our attention to this issue because today in America there is a serious gap between the rate at which our economy grows and the rate at which it produces new, good-paying jobs.

The American Business Conference, a group that speaks for many American firms, recently summed up the challenge by stating that while our economy is growing, the economy is not expanding at a rate to overcome the hesitancy on the part of most of our firms to add new, full-time employees to their payrolls.

Even in an otherwise healthy economic environment, vigorous job creation remains an illusive goal. To meet this challenge, our country needs fresh policies that will enable the private sector to create new jobs and enhance small business competitiveness while permitting productive workers to take home higher pay for their successes.

One potential policy that would reward workers for promoting the productivity of their economy is known as employee partnership pay, and the subcommittee will examine it today.

Employee partnership pay is defined as a pay system in which part of a worker's pay is linked to the achievement of economic goals for the worker's employer. These goals can vary from boosting sales, increasing productivity, to creating more jobs, to raising profits. It depends on the priorities selected.

Employee partnership pay is grounded in the belief that employees should be partners in responsibilities, risks, and most important, the rewards of the company they work for.

Let me illustrate how an employee partnership plan can work. A small business in Portland, Oregon with 30 employees that produces rubber products for use in heavy trucks might be interested in increasing its sales. Rather than giving employees a regular annual wage increase, the firm could establish an annual wage for each employee that they would get regardless of the amount of sales.

On top of that, it could establish a partnership pool that would allow each employee to take home more income based on the firm's achieving a certain sales target. These funds would be distributed to workers annually.

Hypothetically, if the firm had an average year and sales remained the same, the worker's total pay would be just as if they got a typical annual raise. Let us say that the company had a goal of increasing sales by 10 percent and the goal was met. The bonus pool would expand and all the workers would get an even larger partnership check at the end of the year.

If the firm had a really good year and sales went up by 20 percent, the end-of-year partnership check would be still bigger. Thus, there would be a direct, immediate correlation between the success of the firm and the size of the worker's bonus.

It should be noted employee partnership pay has several key differences with other traditional tax-favored employee bonus plans. One traditional plan, the stock option, is available only to the high-wage worker.

In contrast, employee partnership pay would provide a productivity incentive for all the employees. With another such traditional plan, deferred compensation bonuses, the workers don't reap the benefits for 20 or 30 years. In contrast, under employee partnership pay, there would be an annual connection between results and rewards.

Moreover, employee partnership pay need not be tied to just stock price or profit. It could be tied to a variety of financial goals, such as revenue growth, productivity increase or gross profit margin.

The evidence indicates that employee partnership pay may provide a way for our country to bridge the gap between a growing economy and lagging job creation. By lowering an employee's fixed cost of hiring new workers, employee partnership pay creates an incentive for expanding payrolls while also providing a vehicle for making sure workers who produce take home a higher paycheck.

The Chair believes using employee partnership pay could be a real shot in the arm to the small business sector. Small business is the backbone of the economy and the engine of job creation. For example, in my home State, 95 percent of the firms have fewer than a hundred employees, 55 percent of Oregonians work in small- and medium-size firms, and 70 percent of the job growth in the 1990's is going to come from small- and mid-sized firms.

Small business is especially benefited by this model, because using the concept of employee partnership pay will add real flexibility to a small business's operations. Small firms are often cash-strapped, low-margin operations, and by employing partnership pay they will be more likely to be able to keep their work force employed through business ups and downs. Employee partnership pay

is about as flexible as it gets and can be implemented with little hassle and confusion.

Another potential benefit of employee partnership pay is that it would provide a special incentive for hiring young, entry level workers. Since the fixed, marginal cost of hiring an additional worker is reduced, companies will feel that there is less risk in adding to their payroll.

The subcommittee has gathered evidence showing in the companies where it has been used, employee partnership pay has boosted productivity by 3 to 5 percent, a particularly significant amount when you consider that average productivity growth for the economy as a whole has been just over 1 percent over the last 20 years.

Specific examples also show the benefits of employee partnership pay. For example, Lincoln Electric of Cleveland, Ohio is a leading manufacturer of welding machines. It has long been a thriving enterprise in employee partnership pay. Yet, during the devastating 1981 to 1983 recession, when their sales dropped by 40 percent, they laid no one off. It seems that this firm last laid someone off about 50 years ago.

In addition, in Japan, where about 25 percent of pay is tied to performance, the unemployment rate has been extremely low, even through the recent deep recession. Raising productivity is the key to a higher standard of living and the economic recovery is still not providing adequate job security to our workers.

Partnership pay has been successful because it emphasizes partnership. When workers have a personal stake in the company, there is an incentive to work smarter and harder. When owners are partners with their workers, there seems less likelihood of layoffs in bad times.

It is a telling statistic that in Japan, where partnership pay is more prevalent, 93 percent of the workers feel they will benefit from an increase in the company's productivity, while in our country at present only about 9 percent of the workers feel the same way.

At today's hearing the subcommittee will examine the pros and cons of partnership pay and look at various proposals to encourage its use. The Chair would like to stress the subcommittee is not considering ways to mandate the use of partnership pay, but rather to make its voluntary adoption more attractive.

In addition, the Chair is not in favor of abolishing current tax-favored employee bonus plans. The subcommittee will look at the potential value of creating new incentives for employee partnership pay, and in this regard we will examine a number of questions.

First, how can incentives be structured so that management and workers would be interested in employing this new concept? How much leeway should companies have in designing the specific goals and rewards?

Are there ways in which management and workers can team up to design the goals and rewards in their plans? What types of safeguards are needed to prevent companies from manipulating plans to disadvantage a worker?

Finally, it ought to be noted that the tax code today has considerable incentives to encourage companies to boost productivity by replacing workers with machines. In fact, last year such physical in-

vestments received $22 billion worth of tax breaks while investing in workers got about $2 billion.

In today's knowledge-based economy with concerns about job creation so prevalent, our country can benefit through creative incentives for companies to hire workers. The evidence about the positive effects of employee partnership pay on boosting productivity and noninflationary economic growth is promising, and the subcommittee looks forward to hearing from our witnesses as we examine these issues in detail.

Before we go to those witnesses, let me recognize my good friend, Congressman Ike Skelton, who has been so invaluable on so many issues. He has a very tight schedule and I want to thank him, especially for making time to come this morning.

[Chairman Wyden's statement may be found in the appendix.]

Mr. SKELTON. Thank you, Mr. Chairman.

This is a very interesting hearing. I look forward to hearing the witnesses. Unfortunately I do have a conflict a bit later, but I compliment you on this because anything that is positive, with new ideas or old ideas that have not been used such as this, I think we ought to explore them. You are on the cutting edge of so many important issues. My hat is off to you and I compliment you on it.

Chairman WYDEN. The gentleman is a good friend and teaming up with him is about as enjoyable as it gets around this place. I recall our years back when we went to Missouri, and you came to my district. I want the gentleman to know we are going to be teaming up on this one. We will also work very closely with our friends on the other side of the aisle, particularly our Ranking Minority Member, Mr. Combest, who could not be here today, but always pursues these matters with us in a bipartisan way.

We are going to submit his statement into the record in its entirety. In fact, we will hold the record open for both sides of the aisle for Members.I understand my friend's schedule requires him to leave, but we are going to be working closely with him and with Mr. Combest as well.

[Mr. Combest's statement may be found in the appendix.]

Chairman WYDEN. We have five distinguished witnesses, including two who have come from home. Mr. Paul Wenner, the chief executive officer of Wholesome and Hearty Foods.

Mr. Wenner, we would like you to come forward at this time, if you would.

Mr. Burnie Regian, representing the workers of Oregon Steel Mills. If you will come forward.

We have two representatives from American Velvet, a company from Connecticut that has used this for some time: Mr. Wimpfheimer, the CEO, and Mr. Rezendes, the president.

Also, Mr. David Wray, president, Profit Sharing Council of America.

Gentlemen, we have formalities to take care of here, but it will be brief. We are pleased you are here.

Let me give a especial welcome to our friends from Oregon. Mr. Wenner's firm is now, I gather, one of the fastest-growing companies in the United States, a top growth stock. Last Friday, I had the pleasure of having a spectacular lunch at Mr. Wenner's home

featuring garden burgers. It doesn't get much better than that. I want to thank him for coming.

Mr. Regian, we want to welcome you, known for some time for the good work that is going on in Oregon Steel Mills. You have a real success story using the partnership pay model and bringing everybody into the process of striving for higher sales and more productivity. We are delighted that you are here to talk about your innovative management plan.

Our friends from Connecticut, I have heard much about your successes. We welcome you. My dad lives in Richfield, not far from where you are.

Mr. Wray, your organization has worked for quite some time in this area. We welcome you also.

It is the practice of our subcommittee to swear all the witnesses who come before our panel. Do any of you have any objection to being sworn as a witness? Would you rise and raise your right hand.

[Witnesses sworn.]

Chairman WYDEN. Well, gentlemen, we very much appreciate your coming. We are going to make your prepared remarks part of the hearing record, in their entirety. I think it is always best if you just talk. I know there is kind of a compulsion to read all these kinds of statements. But if you would just talk to us for a bit, and try to keep it in the ball park of 5 minutes or so, and we will make your formal statement a part of the hearing record.

Mr. Wenner, we are especially pleased you are here. Why don't you begin. I know you have to go and have the White House start sampling some of their garden burgers later. I know you have some appointments with the people on the culinary staff down there. We are very pleased about that news. Please proceed as you see fit.

TESTIMONY OF PAUL WENNER, CHIEF EXECUTIVE OFFICER, WHOLESOME AND HEARTY FOODS

Mr. WENNER. Thank you, Mr. Chairman, members of the subcommittee and guests.

Once again, my name is Paul Wenner. I am the CEO and founder of Wholesome and Hearty Foods. Wholesome and Hearty Foods is based in Portland, Oregon. We are a public company. We are on the NASDAQ stock exchange. We manufacture and market a line of meatless products. I founded the company in 1985, and took it public in 1992.

With my executive management team and all the employees of Wholesome and Hearty Foods, we run the company under a very strong vision and values statement. The vision and values statement was developed by myself and the employees of Wholesome and Hearty. We all desire to run a socially and environmentally conscious business.

The company's number-one concern has never been the bottom line. We all share the belief that when we do fair dealing, honesty, and offering of healthy, whole grain, Earth-wise products, we take care of the bottom line.

As some of you may know, as Mr. Wyden just mentioned, we were the number-one growth stock in America last year, of all companies on all three stock exchanges. When that fact came out in

the news in January, Fortune and Forbes called me and said, What is this? Everybody was so surprised. But I believe Wholesome and Hearty's success has much to do with the fact that we are always willing to examine new ideas and try new business practices.

That is why I was real enthusiastic about coming here to speak today. I encourage all of Congress and the other branches of Government to continue looking into alternative business practices which will strengthen American business, not only in profitability, but in the treatment of people and employees.

By now I should get to the topic here, the creation of a profit-based compensation plan. I strongly believe that such a compensation method will increase worker productivity. There is no doubt in my mind. This compensation package would give workers something they desperately need; another reason to do a good job, a reason to care about what they do and what they make.

At Wholesome and Hearty we operate under what is called a TQC, total quality management. Employees are encouraged to examine processes and determine if they are being done to the greatest efficiency or if they can be improved.

You would be amazed what savings have been captured by these ideas brought to management's attention by line workers, and the enthusiasm with which these ideas are given once they are recognized by the management who listen. Workers become more involved not only in their job but in the entire company; more concern about health, more areas where the company can grow.

At Wholesome and Hearty Foods, every employee from the lowest to the highest paid—and there is really not a large space between those two—the common belief that we are doing good, we are offering healthy, environmentally helpful products is real key.

The common goal has been increased productivity, greatly increased awareness of company dealings. From this comes a sense of ownership; from a sense of ownership comes better products, more savings and a stronger company. Of course, then we have a stronger economy and a stronger America.

I recently had employees inquiring how they could have more ownership in the company. We have examined the ESOP's and other alternative compensation methods. Both the management team as well as myself believe that the profits-based compensation package that you are talking about would increase this sense of ownership quite a bit, and in fact, and establish other benefits that come with a sense of ownership.

In addition, I believe a greater bond between management and labor would be created under a compensation plan, since both management and employee's compensation would depend on one another and on increased profits, stability, and company strengths.

I also believe that a profit-based compensation package would increase employee stability. While it is true initially there may be some apprehension toward a compensation package, employees may be unsure about their wages from pay period to pay period. I believe they will come to realize there is more stability due to the fact that corporations who adopt such a method will be able to maintain their employees, have less layoffs in downtimes.

I further believe that implementing this profit-based compensation will begin to accomplish what business needs more than any-

thing else right now, and that is a creation of a fundamental shift in the way companies do business today. It is true there are some companies such as Wholesome and Hearty Foods who may implement such a plan without a tax credit, but most companies probably will need some kind of incentive to try something different.

That is why I am here today, to encourage the subcommittee and Congress to allow for tax benefits to companies that can implement this profit-sharing compensation package and give companies a reason to strengthen our economy, give employees a better sense of ownership, and reduce unemployment and strengthen the economy by implementing this profit-based compensation.

I also believe providing the taxpayers for-profit-based compensation would eliminate to some degree lawsuits which companies who adopt such policies may face from shareholders under a theory that such practices may be not a legitimate business practice.

I encourage all people here today to work toward providing companies with alternative business methods as well as safe havens for the litany of frivolous lawsuits which plague both small and large businesses in this country.

Basically, I would like to thank the subcommittee and everyone here, and I can answer any questions if you had any questions you want me to answer for you.

[Mr. Wenner's statement may be found in the appendix.]

Chairman WYDEN. Mr. Wenner, thank you very much for an excellent statement. I think it is particularly interesting to note that with you doing so well at present, and the fact that that your standing is so elevated, that you are thinking in terms of increased productivity.

I thank you for coming and for an excellent presentation. The chance to get acquainted has really been inspiring and we are very appreciative.

Let's go next to Mr. Oregonian, Mr. Regian. I want to tell our witnesses we don't get as many Oregonians back here in DC as we would like, so when we do we kind of splurge a little bit.

Mr. Regian, we have known you at Oregon Steel for many years. Please proceed with your statement.

TESTIMONY OF BURNIE W. REGIAN, EMPLOYEE INVOLVEMENT FACILITATOR, OREGON STEEL MILLS

Mr. REGIAN. Thank you Mr. Chairman, honorable subcommittee members. My name is Burnie Regian. I live in Vancouver, Washington and I work for Oregon Steel Mills in Portland, Oregon. I have been employed by Oregon Steel for 5 years and presently supervise the employee involvement program at the Portland facility. I have worked in this position for 2 years.

In my first 3 years of employment I was an industrial electrician in the plate rolling mill. My previous employer was the U.S. Steel Corporation, for 18 years, in Baytown, Texas. There I worked as an industrial electrician. U.S. Steel permanently closed the Texas works plant in 1986.

The central issue on which I wish to speak is, what are the potential benefits of alternative pay plans for companies, their employees, and the economy as a whole. My statements are from my

experience in working with two steel companies, with two different management styles.

In 1985, Oregon Steel Mills, Portland Division, started a profit participation plan for all of their employees. Today, 20 percent of quarterly profits are paid to the employees at OSM's Portland Division. The employee's portion is the percentage payable of 3 months of their basic salary. For example, if an electrician's pay is $3,000 per month or $9,000 per quarter, and the profit participation for that quarter is 30 percent, the quarterly bonus for that electrician for a quarter would be $2,700.

At an average of 30 percent profit participation for the year, the yearly bonus would amount to $10,800 bonus for the electrician and his family. Even though OSM employees enjoy an exceptional benefits package, profit participation is regarded by these employees as one of their most outstanding benefits.

What are the potential benefits of alternative pay plans for companies?

Since Oregon Steel has implemented the profit participation plan for its employees, production and quality records have been at an all-time high. The morale of its employees has been enhanced. Sharing in company profits has promoted a feeling of being part of the company, not a piece of the company.

Last year, at the OSM Portland plant, a cost awareness project was initiated by the plant employees. OSM vice president and general manager, Portland Steel Works, Joe Corvin, explained that out of $1 saved by the elimination of waste and recognized as profit, 20 cents goes directly to the employees as profit participation. OSM employees responded to this project by eliminating waste and recognizing $210,000 in savings for the last 4 months of 1993. Increased production and quality, enhanced employee morale, a feeling of belonging, and recognition of costs and waste by employees are potential benefits of alternative pay plans for companies.

What are the potential benefits of alternative pay plans for employees?

Employees privileged to have profit-sharing as part of their benefit package should never rely on profit-sharing as part of their regular base pay. Profit-sharing should be recognized as a bonus. This bonus is the biggest potential benefit an employee receives in a profit-sharing plan. The employee is recognized by the employer as giving extra effort and is compensated for that effort. If there is a downside to profit-sharing, it is that some employees rely on the bonus as part of their regular wage package and a reduction in profits produces little or no bonuses.

Job security for employees could be a potential benefit of profit-sharing. Customarily, in the steel industry, the last quarter of the year is the worst economically. In my former employment, approximately one-third to one-half of the employees in my plant could be expected to be laid off from their jobs because of lack of customer orders in the last quarter of that year. They would not return to their jobs until business increased 3 to 5 months later.

Customer orders at Oregon Steel's Portland facility in 1989, 1990, and 1991 were very good for those quarters. But in 1992 and in 1993, Oregon Steel experienced what the rest of the Nation's steel companies experienced, slow business. But, instead of follow-

ing the tradition of laying off employees, OSM management opted to operate without layoffs. This decision meant that profit participation for those quarters would be zero, partially because those profits that could have been recognized were paid in salaries to those that would have been laid off.

The flexibility offered by a profit-sharing plan helped make this decision possible. The first quarter of 1994 at OSM paid employees only 6.75 percent profit participation, yet in the first half of 1994, steel producing and plate mill operations at OSM broke record productions. Even though profit participation remained low, efforts by employees remained high. Increased compensation and job security for employees are potential benefits for alternative pay plans.

What are the potential benefits of alternative pay plans for the economy as a whole?

When companies share their profits with employees and in return receive extra effort from their employees, it enables them to raise their productivity and quality and better compete in the marketplace. This ability to compete provides job security not only for their employees but for their vendors and suppliers. Utility companies benefit. Local governments benefit. Local merchants benefit. The company as a whole benefits.

I worked for a company for 18 years and that company became unable to compete in the marketplace and closed its doors in 1986. The local economy was devastated and unemployment in our community was 19 percent. From my experience, I feel that employees in that company had had a feeling of belonging, of being a part of the company, and been able to be a part of a cost reduction effort as well as participating in profit-sharing, that plant would still be operating today.

I would recommend that other companies and their employees adopt profit-sharing plans. In 6 short years, our country will be 224 years old and we will be ushering in the 21st Century. In order for small business to compete in the 21st Century, not only in America, but also in the world market, employees will have to be involved in the workplace. If employees are involved, profit participation needs to be a part of that involvement.

In closing, may I note that if employees are involved in company profit-sharing, those employees also need to be empowered in the workplace to accept responsibility and accountability for their actions and share in decisionmaking on their jobs.

Thank you, Mr. Chairman and subcommittee members.

[Mr. Regian's statement may be found in the appendix.]

Chairman WYDEN. Thank you. Also very helpful presentation, and I think it is particularly helpful in the way you have highlighted how the concept cuts both ways. This is something that allows everyone to share when times are good, but it also requires that you work harder and work even more aggressively in partnership when times are tough. As you highlighted in the instance of a company that might be with us today had they had it, it can make a real difference. I thank you for an excellent presentation.

Why don't we go now to our friends from American Velvet. Why don't we begin with you, Mr. Wimpfheimer. Then we will have Mr. Rezendes as well. If you wouldn't mind, push that microphone a little closer toward you, and please proceed.

TESTIMONY OF JACQUES WIMPFHEIMER, PRESIDENT, AMERICAN VELVET CO.

Mr. WIMPFHEIMER. My name is Jacques Wimpfheimer. I am president and chairman of A. Wimpfheimer and Brother, who own and operate American Velvet Co. in Stonington, Connecticut. We began as importers of pile fabrics around 1845 in New Hampshire, but have been manufacturing light-weight velvets in the same building in Stonington since 1892, over a hundred years. We make light-weight material primarily for the dress and needle trades, as well as for jewelry box, photographic and casket manufacturers, and retail.

American Velvet employs approximately 250 people. It is a family business. I am the fourth generation and my son who is also in the business represents the fifth. For the past 30 years we have had a weaving plant in Orange, Virginia that employs approximately 30 people, and also own and operate a plant in Yorkshire, England that employs approximately 175 people.

I will add to that, in Stonington we have one union, in Virginia we have no union, and in England we have three or four unions. All plants have profit-sharing.

We started a profit-sharing plan in 1940 that distributed our profits after taxes in cash. This was quickly changed to a before-tax cash distribution, and 5 years later to a combined plan that was one-third deferred, two-thirds cash. The deferred portion had obvious tax benefits in that it was not taxed until distribution at retirement.

We changed to an all-cash plan in the 1970's because our deferred fund had not performed well for several years. Employees felt that as it was their money, they were vested and had the right to handle it as they wished. We let them vote it out, and since then we have had an all-cash plan. In retrospect, probably a bad move on our part.

In general, profit-sharing plans should be tailored to the needs of the organization. Over the years we have made minor technical changes. However, fundamentally it is the same one we began with roughly 20 percent of our profit put into a fund. We divide our payroll into it and find a percentage figure. Each member of the plan is paid that percentage of his yearly earnings from the fund.

Looking back, I think that the best plan would be one that is 100 percent deferred with participants permitted to decide each year to take a portion in cash, if they wished. The tax benefits of a deferred plan are too good to pass up for an all-cash distribution, but there are times in one's life when cash is preferable. Younger employees would probably take more cash to meet immediate obligations: Starting a family, school, houses, cars, et cetera, while older employees would probably want to save as much as possible for retirement.

There should also be a choice of different types of funds to invest in: Stock, savings, interest bearing, growth, et cetera. Ideally, I would like to see some tax benefits for the cash distribution profit-sharing, but it is hard to figure out what that could be; perhaps for school/college tuition, down payments on homes, health care, which is already covered, or something of that nature. Tax benefits for deferred plans are pretty good as they exist.

Profit-sharing has come about because there are many of us who have known for a long time that there are important built-in weaknesses in the normal labor/management relationship. They are two-fold and interrelated: One, employees have little or no opportunity to directly and immediately participate in their company's prosperity; and, two, employers have not found adequate means to express recognition and appreciation for the interested efforts of employees, in direct proportion to company success. It is to meet these needs that profit-sharing is employed. It does enable employees to participate in, and management to reward for the success of the company as, or if, it prospers, above and beyond existing wages and fringe benefits. Profit-sharing is not a substitute for good competitive wages; it is in addition to them.

Just as an aside, Mr. Regian, you mentioned profit-sharing as a bonus. We don't permit that word to be used in our place. Profit-sharing is earned by everybody.

Mr. REZENDES. He doesn't permit it.

Mr. WIMPFHEIMER. Advantages to profit-sharing: one, it is an important cog in the co-partnership, participative concept of total quality management, TQM. Two, it is a major incentive reward for work well done. Three, it dampens high-low fluctuations in business and wage cycles; makes longer contract commitments more acceptable for both parties.

Four, it fits hand-in-glove with TQM Programs.

For a proper system and plan to be effective, employer and employee must be completely aware of whatever is going on in a business—good, bad, production, quality, market, fashion, competition, future, and costs.

Five, cash plans put more money immediately into circulation.

Profit-sharing can also be used to dampen inflation. In June of 1970, when the Nixon administration was considering controls to stop spiraling wages-prices, I wrote them a letter suggesting: "Profit-sharing incorporated into wage-price controls offers flexibility on the wage side that is most desirable and by itself tends to dampen the demand for fixed-wage increases, and most importantly, at the same time, creates and rewards increased productivity and builds understanding and cooperation between labor and management, a gap we all agree needs closing."

Disadvantages: Profit-sharing is not all good. One, it cuts into cash flow, two, deducts from bottom line and dividend distribution to passive investors. Three, where it exists, it is an obligation that any purchaser of a company or part must accept.

Fourth, in our case, it is in our contract with the union and must be negotiated.

Fifth, it makes it close to impossible to accumulate capital for repurchase of sole owner stock to pay taxes.

Sixth, total employee compensation fluctuates each year based on profits. This can make cash profit-sharing difficult for some employees to manage.

We have had years since 1940 when we had zero profits and we have been as high as giving 39 cents on every dollar. A confusing contradiction or anomaly does exist when one realizes that one has to work harder when times are bad for poor or no rewards, and

when times are good work somehow is easier for better rewards. One learns with time to balance good and bad.

We are totally convinced that profit-sharing has been a great help to us in surviving the last 50 years. Fifty years ago we had 10 or 12 competitors in the United States. Today we have two. We are still manufacturing in New England at quite a severe handicap as compared to our competitors who are in the South.

I would always advise one to look into profit-sharing and use it if they are willing to work at it. It is not a situation where you can turn on a faucet and forget about it. It is absolutely imperative that if it is to be the great aid it can be, it must be worked at all the time by both management and employees. Our union does a great job alongside of management. Together we make it work.

I would just like to add to this the fact that this was put in in 1940, at the end of a 16-month strike called by the union. Since then, we have not had a strike and we have not gone to arbitration to solve a problem. The employees—through their union—and management solve everything face-to-face.

[Mr. Wimpfheimer's statement may be found in the appendix.]

Chairman WYDEN. Very well said. I think it is especially exciting to see you end on the need for labor-management cooperation, because that is right at the heart of this. This only works if everybody can see there is an incentive for proceeding in this kind of way.

You mentioned your experience with the deferred compensation arrangement. There is no question about the value of that. That gets favorable tax treatment. We are talking about whether or not there is something out there of real value that people could see on an annual basis, that would also get favorable treatment.

Thank you for an excellent presentation.

Mr. Rezendes, welcome. I know you have been working very closely with the firm, and your union has for many years. This subcommittee works very closely with labor groups on these kinds of issues. We welcome your involvement.

TESTIMONY OF TOMMY REZENDES, AMERICAN VELVET COMPANY, LOCAL PRESIDENT, AMALGAMATED CLOTHING AND TEXTILE WORKERS UNION, AFL–CIO

Mr. REZENDES. This is my first subcommittee meeting. My name is Tom Rezendes. I have worked for American Velvet for 26 years. I do the purchasing for American Velvet. Currently I am president of Local 110-T, AFL–CIO.

Profit-sharing, as far as I am concerned, works very well at American Velvet because everything at American Velvet is open. Because of my line of the work, I can see where money is being spent and I can talk to employees about it. If we have any questions about orders or where money is being spent, we go to the main office, we talk with Mr. Wimpfheimer, he has the books there, and we look at the books every morning at the morning meetings. Every morning at the morning meeting we look at management and a union rep would go up with me. We talk over the problems.

Really profit-sharing at American Velvet is totally different than probably anybody has ever seen, because American Velvet is so small, and everybody is like a family there. We know everybody on

every shift. One way or the other, everybody is related, and so it makes life a little easier.

What we stress to our workers while we are there is if there is a quarter yard of bad cloth, don't cut off a half a yard because at the end of the year you are throwing a lot of money out the door. To maintenance, their machinery, keep the maintenance up. Don't wait for machinery to break down before you decide to fix it.

Basically that is all I have got to talk about, other than what you read in my written statement. But that is all I have to say on that.

[Mr. Rezendes' statement may be found in the appendix.]

Chairman WYDEN. You are probably being too logical for the U.S. Congress to absorb in one session. As you said, if you cut more bad cloth than you have to, and it comes out of everybody's hide, some people are less likely to cut excessive amounts of bad cloth. So, you have put this in a way that makes it real clear that this doesn't have to be rocket science.

Mr. REZENDES. Under 5 minutes.

Chairman WYDEN. What this needs to be is something that gives something to people. You meet with your associates at the firm essentially every day. We are not talking about just hands-on. We are talking about hands never getting off. That is just fascinating.

We will have some more questions for you in a moment. You have probably set the all-time congressional speed record for testimony.

Mr. REZENDES. Mr. Wimpfheimer will tell you, I don't like long meetings.

Chairman WYDEN. It ought to be a model for the rest of us. We thank you for it.

Mr. Wray, welcome.

TESTIMONY OF DAVID WRAY, PRESIDENT, PROFIT SHARING COUNCIL OF AMERICA

Mr. WRAY. Thank you, Mr. Chairman, for this opportunity to talk about profit-sharing.

The Profit Sharing Council of America is a national, not-for-profit association. It was established in 1947. We have approximately 1,200 members that sponsor profit-sharing plans for their 2 million employees. Member companies range in size from small entrepreneurial businesses to Fortune 500 companies.

PSCA offers its members practical assistance with plan design, administration, investment and compliance and communication. Nearly 50 years ago the PSCA came together in the belief that sharing profits are employees, those people who make profits possible, was good for America. They believe that if profit-sharing was widely adopted by American business, then the U.S. standard of living would improve as businesses would be more profitable, pay to employees would be increased, and labor stability would be increased. A very idealistic view, but one that has been clearly followed by the Profit Sharing Council since 1947.

As you asked, I won't read my testimony, I will make a few comments as we go along. Clearly academic studies show that profit-sharing increases labor stability, organizational commitment, productivity and profitability. I would like to comment, however, on what the companies say.

The Profit Sharing Research Foundation, which is affiliated with the Profit Sharing Council, did studies of Profit Sharing Council members in 1988 and 1989, and asked them why they put in profit-sharing plans, and then asked them to evaluate how successful those plans had been.

Of course the typical answers are increase employee retention, increase employee interest in the firm, build a sense of employer/employee partnership, provide a group incentive to motivate productivity, serve as a recruitment tool, increase or stabilize profits, enhance employee job security, provide supra-wage benefits without a fixed commitment, lower costs, serve as a group incentive to increase safety, provide a variable wage component, and to lower price.

So you can see companies put in profit-sharing for a very wide range of reasons and not necessarily just the ones we have talked about here this morning.

What is interesting in the evaluation process is that, when you rated all of those and you took either great or moderate success valuations all but two came out pretty well.

The two that didn't were a group incentive to increase safety and to lower prices. Profit-sharing did not seem to do either of those two things, in a satisfactory manner, but the rest of the purposes identified by companies were achieved. Profit-sharing meets a wide range of goals in addition to the ones that we have talked about typically when we talk about profit-sharing.

Why do companies put in cash profit-sharing?

Profit-sharing is easy to administer, it is easy for employees to understand, it is very immediate, it is very focused.

The second thing is, of course, it is based on profits so there is financial flexibility in the management of the enterprise. You don't make fixed commitments. These things are all very straightforward and other people have talked about them.

I thought I would mention just a little bit about some of the specific aspects of profit-sharing. There are two parts of profit-sharing. One is how much money goes into the pool that is going to be divided among the employees, and the other is how is the pool divided among the employees.

Mr. WRAY. There are two principal ways that the pool is developed. One, the most common, is what is called discretionary profit sharing, and that means that the owners at the end of the year say, hey, we've had a good year, we're going to give everybody a thousand dollars. There is no fixed formula, there is no particularly identifiable relationship to profits and you don't open the books to the employee. It's just a very straightforward, if things went well for us, we share. Actually, I think that's probably the most common type and a lot of people don't even call it profit sharing.

In that case, they are bonuses to share in the good productivity and profitability of the company at the end of the year—primarily in smaller companies. Another approach is to use a formula, and the formulas are all over the lot.

I did a study of 200 profit sharing plans that had formulas and found out that there were no two alike. These plans are individually tailored to their particular business and employee needs, and so formulas come in all shapes and sizes. Some are very simple,

some are extraordinarily complex, and they key off of different kinds of factors, but of course all based on profits.

After a company has determined the amount in the profit sharing pool, the next question is, how is the money divided up among employees. Typically, the money is divided up based on a compensation basis, so that it usually is divided on a proportional basis based on compensation in the workplace. However, there's the ability in profit sharing to be creative.

Companies work in performance evaluations through what's called a point system. They give one point for each dollar of compensation, for example, and then they will have rankings or performance evaluations and give additional bonus points based on these evaluations.

It's fun to talk about Proctor & Gamble's original plan, which was put in in 1887, the first cash profit sharing in modern times. They tied their cash profit sharing to a performance system. They gave 1½ shares to good performers, one share to average performers, and then those, "lazy and shiftless men," got no shares at all. So even back in 1887, there were performance connections with profit sharing. So, a very flexible approach is provided by cash profit sharing.

Certainly we need to encourage cash profit sharing and government incentives may be necessary. The reason for that is that profit sharing really is two things. One is, it's very much based on corporate culture, and second, it is a fairly risky adventure for management.

As Mr. Wimpfheimer says, this is not something to be entered into lightly. Profit sharing, if it's improperly implemented, can have devastating effects at an organization. But more importantly is the cultural issue. Profit sharing really is based on a belief that workers and owners can work together, they can achieve together, they should share together. But that requires a belief that employees can bring something to the table. They are not automatons to be plugged in and worked as hard as possible and then thrown away and new automatons or new widget people pushed into the machinery. So, it's a different kind of philosophy that is involved there.

It's very interesting, I was talking to the people at S.C. Johnson Wax in Racine, Wisconsin about this one time, because we're always trying to do studies and publish studies that show profit sharing works, because then we can show these to corporate people, and say, you should put in profit sharing, look, here's a study. The people up in Wisconsin, they said, quit doing that. They said, that's worthless.

Profit sharing is like religion. You either believe that people can make profit sharing work, that the employees really can be made partners, or you don't. If you don't, no amount of academic or other kinds of studies are going to be persuasive. So, it is truly a cultural issue, a corporate cultural issue.

Certainly some kind of incentives, I think, will enhance the opportunity or encourage people to experiment with profit sharing, which I think will begin to teach people who the benefits are worth some of the risk to sort of corporate culture beliefs that exist throughout American business today. I would mention briefly as well that there are profit sharing—cash profit sharing incentives in

other countries. The U.S. is probably behind the curve in this regard.

Certainly, in Europe, most countries have incentives and certainly there's a lot of interest right now in cash profit sharing in Eastern Europe and even in the Soviet Union. So, the review of cash profit sharing is going on all over the world.

I would also mention, of course, deferred profit sharing as well is being reviewed for different purposes.

I guess I would wrap up and say that cash profit sharing certainly is not a new concept. As I say, Procter & Gamble pioneered the modern version in 1887, so it's been around a long time and it provides many benefits to employers and employees. However, it is still very much not a common practice.

Only a few companies really practice cash profit sharing. Certainly the Profit Sharing Council applauds government efforts to foster an environment that encourages more companies to do cash profit sharing, and we offer all of our assistance in helping you achieve this goal.

Thank you very much, Mr. Chairman.

[Mr. Wray's statement may be found in the appendix.]

Chairman WYDEN. Thank you very much for your excellent testimony, Mr. Wray. We're anxious to work closely with you and your organization because you've been out there on the front lines for a lot of years and have already achieved considerable success.

Let me begin, if I could, with you, Mr. Wenner. I gather that you all have some version of a 401K plan at this point. Is that correct?

Mr. WENNER. Yes.

Chairman WYDEN. Now you're looking at other kinds of compensation, such as approaches that involve your employees and enhance productivity. I would be interested in knowing what you think at this point would be most helpful, if you could put your wish list out there in terms of other kinds of arrangements for enhancing productivity.

Your company has done very, very well with what you have, and yet to your credit, you are trying to push the envelope some more and try and look at other kinds of approaches. I think it might be helpful to have you sketch out for us where you would really like to take this in terms of additional approaches that would involve your employees and enhance productivity.

Mr. WENNER. Well, I'm always trying to figure out how to balance the public market with doing as much as you can for employees, which is a tough thing. Because all eyes are upon you, especially when you have such growth like we have. But I believe that this profit sharing idea is just ideal.

I thought about it over the years even though I don't know that much about it. I mean, this is—until the last week or so, my first real exposure to a profit sharing plan. Looking at ESOP's was one option, but I like this idea a lot better. But if some way—of course, we'd have to have some help with the variety of folks to figure out how to set this up. Sounds like there's a lot of different options to chose from.

It's amazing though, as far as benefits, one of the biggest benefits our employees have responded to is free massages. I mean, we have given them all medical and dental programs, along with vision and

so on. When I hired a person to come in twice a week to give employees a massage, they got the most excited about this program than any ever incorporated. What is really amazing is that it was quite inexpensive.

To go out and get a massage of course would probably cost $35 to $40. So, actually, in a way, that is a cash incentive plan.

Chairman WYDEN. I think the massage industry is going to benefit greatly in our country if people see that's the ticket to becoming number one as a growth stock.

Mr. WENNER. Well, that's one of the many small ways that we do business differently. But I am very interested in knowing how to set up a profit sharing plan. We've talked about it with our management team. We have three or four people who really run the company as of the first of the year. I stepped out to do PR, that sort of thing.

So we really don't have the traditional sort of president, CEO, et cetera, it's a team concept. The team management has been working quite well at W&HFI, and the team feels like this is a really good way to run a business, which benefits all the people who work there.

People mentioned a family. We are a lot like a family, although we speak three different languages at Wholesome Hearty Food. We have a third Russian, a third Spanish, and a third English. We've incorporated language courses, which has helped communication around the plant.

So this is one of the big challenges, how do you communicate to these people that you're sharing the profits? So, that's one big hurdle to get over.

Chairman WYDEN. Is it your sense that it is important to have something that can be seen fairly quickly? The concern about the deferred compensation is that 20 years down the road you see something. What we have heard, particularly from workers who have modest kinds of salaries and the like, that there's a real need to be able to see something at the end of the year, something that you can identify with in terms of——

Mr. WENNER. I think even at the end of the year would be too long a period of time for them to wait. I think it would have to be quarterly. But because everybody does need that money. I believe it should be a choice for all employees. Whatever money that you make available should be their choice and explain to them the options of how they can use their money. They can take it now, buy a car, or whatever, or they can take it long term.

Chairman WYDEN. Let me ask you about this point you touched on in your testimony about the frivolous lawsuits over your compensation methods. I gather you feel that if there was a tax credit or something where the government set a standard for creating an incentive, you and your folks there at Wholesome and Hearty think that that might also be of some protection against frivolous lawsuits and shareholders saying they should have it rather than the workers.

Is that——

Mr. WENNER. Yes. You know, we're just—to me, there's so many things that you can get sued over, just almost anything. It's just

that we'd like whatever kinds of protections we could have, especially in this area.

I mentioned this plan to a couple stockholders just in passing—some people who called me on the phone—they aren't involved in our company except for being outside stockholders, and, boy, this one fellow got all nervous about sharing profits. You're going to give money to the employees? I'm unhappy—that's socialism. I said, those are the people who are making our company grow. I said, we have to reward them.

I was surprised at this person's response. But I believe you have to look at companies as people. We have to reward them—and, yes, to protect the company from any kind of frivolous lawsuits. A lot of stuff can really take your energy and your time, when you try to do something productive.

Chairman WYDEN. Well, we're very concerned about frivolous lawsuits generally. We've got too many of them in our society, whether product liability suits or medical malpractice suits, we've got too many of them. Your point is well taken there.

Mr. WENNER. Thank you.

Chairman WYDEN. I appreciate it. Let me move on, and I want to make sure I'm not doing too much violence to pronouncing your name. Is it——

Mr. WIMPFHEIMER. You're doing very well. Wimpfheimer.

Chairman WYDEN. Thank you. Maybe move on to, is it Mr. Regian?

Mr. REGIAN. Regian.

Chairman WYDEN. All right, excuse me, Mr. Regian, maybe we will start with you here, and we'll go right down the line. From your perspective, have the added job security and the extra rewards in the good years that have come with profit sharing, balanced the risk of getting no extra money in the bad years?

Mr. REGIAN. Yes, sir, I do. There are three benefits that influenced my decision to go to work at Oregon Steel. Those benefits were profit participation every 3 months, and ESOP plan where the employees received stock yearly, and a 401K plan. Job security and these benefits, in my opinion, far outweigh most of the benefits in the rest of the steel industry and balance the risk of getting no pay in the bad years.

Chairman WYDEN. Before we go much further, let me ask Mr. Rezendes exactly the same question. From your perspective, based on what you have faced, has the added job security and the extra reward in the good years that come with profit sharing balanced the risk of getting no bonus in bad years?

Mr. REZENDES. Yeah, we had a couple years that we didn't have any bonuses, '80 and '81, I think. There's a lot of frustration, and a lot of finger pointing, a lot of why, why, why. If we just turn around, where are the causes of it, some of it, and the cost of production is down and nobody is buying the cloth, we're going to get zapped.

It's a difficult time up at the mill when we don't have a profit. Our quality is affected by it. People are not paying attention to the quality. You might go 2 or 3 months where they're just not giving a darn about the profits. Then we're getting hit again the following year, because they're neglecting what they're supposed to be doing,

and then sales are no good, we're hit again. It's a difficult time when there's no profit.

Chairman WYDEN. I gather you feel that in saying that it's a difficult time with no profit, but you still support the concept, the reason you support it is when it's a difficult time, everybody shares the difficulty. It's not that the person down on the bottom takes a big hit and faces lots of difficulty——

Mr. REZENDES. No, it's all of us, from New York, from our sales office right on down. The first thing we say to Mr. Wimpfheimer, tell the people in New York to get off their rump and sell cloth. So, nobody's excluded from it.

Chairman WYDEN. Nobody's exempt from sharing——

Mr. REZENDES. That's right, everybody takes it.

Chairman WYDEN. All right, very good point. Let me move back to you then, if I could, and ask, overall, do you at Oregon Steel think that the concept of employee partnership pay improves the work environment for the employees?

Mr. REGIAN. Yes. Along with pay goes employee empowerment and employee involvement. With profit participation and other company benefits, the employees are recognized as being part of the company, not a piece of the company. They have their input, they are listened to, and what they say is very important in solving problems in our plant.

Sure. I think along with that pay goes employee empowerment, employee involvement, and that's my job, oversee the employee involvement program at the plant. Along that, with the profit participation, the other benefits they get, they seem to be a part of the company, not a piece of a company. They seem to have their input, they're listened to and what they say is very important to solving problems within our plant.

Chairman WYDEN. Now, at U.S. Steel, that was where you were before you came——

Mr. REGIAN. Yes, sir.

Chairman WYDEN [continuing]. came to paradise, got to Oregon, you said that they didn't have an employee partnership plan; is that correct?

Mr. REGIAN. No, sir, they did not.

Chairman WYDEN. Did you get the sense that the employees at U.S. Steel cared as much about increasing productivity as your colleagues and coworkers now at Oregon Steel?

Mr. REGIAN. No, sir, they didn't. We worked under contract and employment and enthusiasm in the workplace was not as good. The relations between workers and management was not good. There is a big difference between that management style and the management style at Oregon Steel.

Chairman WYDEN. Tell me a little about that, because I'd be interested in that. What is the labor-management situation at Oregon Steel? Do you see partnership pay as one of the things that really has been determinative of that labor-management?

Mr. REGIAN. Yes. Employee and management relations at Oregon Steel are very good. Not only the benefits employees receive but the fact that they have a say in the workplace contribute to these relations.

Chairman WYDEN. Let me maybe move on to Mr. Wimpfheimer. We reflect on the success you've had with profit sharing at American Velvet, and also note Mr. Wray's comments. There still aren't a lot of people who do it. What in your view are some of the major reasons that other firms aren't adopting this kind of employee partnership pay concept?

Mr. WIMPFHEIMER. My father was one of the founders of the Profit Sharing Council of America and with him were the heads of a number of companies, large and small, who had the same labor/management philosophy and were strong enough in their own companies to initiate what they believed in. Along with them were some others who felt that profit sharing would protect them from labor organizations and unions. They, in fact, were offering more than unions were requesting. The latter group was influential enough to keep labor representatives off the council's board. I followed my father on the board and attempted for many years to have labor represented, that it was a labor/management philosophy. However, I was not strong enough to gain them representation and eventually resigned in protest. The organization is good and the research excellent.

Originally, profit sharing was answering the problem that unions could get them, and there were companies definitely that wanted to keep union or labor out of this picture. In fact, the reason I eventually left the organization myself was because I couldn't convince them that labor was the other half of profit sharing. Their organization does not permit representation from the unions. So,—or it never worked out that someone from the unions was on their board.

Now, truly, just as David said, you either have to be convinced that profit sharing is a good thing or don't go into it. It doesn't take care of itself. You have to work like hell at it. You have to believe in the philosophy, from the very beginning. Those are reasons I think a lot of companies do not put it in.

It is difficult to think of selling a company that has profit sharing as, perhaps, as much as 50 percent of the profits each year are distributed as profit shares to employees. To a potential buyer or stockholder, that presents a problem. It is one I face, as ours is family owned and inheritance taxes will demand perhaps more than my heirs or the company itself can afford to pay at my death. If I should try to sell it now myself, I would have a huge capital gain tax to pay and then along would come inheritance taxes. At the moment this is an almost insoluble hurdle for family owned companies. In the latter case the family would only end up with roughly 25 percent of the value.

Mr. WENNER. I don't have profit sharing yet.

Mr. WIMPFHEIMER. I would think that your stockholders are going to raise a little hell. Now there are plenty of public companies that do have it, and my business, yes, we've survived for over a hundred years, but we don't make—we're not a high profit organization. We don't have a new product. You mentioned in Lincoln Electric, they have a product all their own that no one else makes, there's no competition.

You, a bit, are in a situation like that perhaps now and you're a developing company, and there's a whole new market. But again,

we've been around a hundred years, and all I can do is tell you about companies that have left our business. If there was something in the system that could provide accumulated earnings tax credits, for instance, would permit a company like mine to establish a fund to buy back stock when taxes come along, to help a family preserve or retain its business—that would help.

Now, on top of that, I feel very responsible for my employees and actually for the town I live in. Because the town is fairly dependent on our business. If it has to be sold, I don't know that the next person is going to come along and be happy to survive on what we survive on. An adjustment in the area of inheritance taxes can help hugely.

Chairman WYDEN. It's very interesting that you raise this matter of the capital gains, because I am working on a package of four bills for small business. Simply, partnership pay is one of one of them, but one of the other components of this four-bill package will be to index capital gains for inflation so that you will not see this bite that you describe being so draconian.

The other thing I am looking at is the idea that if, for example, you sell your business and you decide you want to take a decent chunk of those proceeds and invest in another small business, but perhaps not retire full time. We ought to say that that will not bring you another great clobbering from the Internal Revenue Service. So, your points on the tax consequences are very relevant.

Let me ask you just one other point.

Mr. WIMPFHEIMER. Could I add to just what you're saying?

Chairman WYDEN. Sure, sure.

Mr. WIMPFHEIMER. In recognition of this problem, we went to the union a few years ago and they agreed with us, to reduce the amount of money that was going into the profit sharing plan, about 15 percent. That was just to try and protect the situation. However, we have, it's turned out, used this 15 percent and more to invest in other businesses trying to spread a bigger base.

Now, just one—if you——

Chairman WYDEN. Please, sure.

Mr. WIMPFHEIMER. One more thing I would like to say, and that's maybe 20 years ago or less, I ran into the Consul General of Yugoslavia in New York City, and he couldn't believe we had profit sharing. I invited him up to the plant and he sat around with a whole bunch of our employees, including the head of the union, which wasn't Tommy in those days, but had a hell of an argument.

He said, "but profit sharing is the highest form of communism." Here were my employees, who were fairly militant in their own way at that time, saying, "no, it's the highest form of capitalism." This was a nice argument to have go on.

Chairman WYDEN. Well, a nice argument and directly relevant to this debate. Let's face it folks, there is really something out of kilter here because the economy is growing, yet the number of good paying jobs is not keeping up with that rate of economic growth. We are going to have to come up with some things, that I believe can be done with the free enterprise system.

Mr. WIMPFHEIMER. I want to see what the economy is 5 years from now. Because, yes, it's growing, but one of the main reasons it's growing is because companies took a look at themselves and

saw how fat they were. Really, it's sad to say, but certainly in New England, they've collected themselves and done a better job they have gotten rid of fat and sadly a hell of a lot of jobs. It's a shame but that's really what's adding to their bottom line.

Productivity is really what they have developed and actually working with employees, the ones they have, have eliminated an awful lot of jobs.

Chairman WYDEN. That is——

Mr. WIMPFHEIMER. It's a shame.

Chairman WYDEN. That is true all over the country. In our part of the world, if you're in the timber business today, you have survived some very, very tough years, and you are lean, and you are modernized, and you are using state-of-the-art computers. My sense is that you can see much of the same parallel in the defense industry and parts of the country that are so dependent on defense.

Let me just ask you one other question before I lose it for the record, Mr. Wimpfheimer. You said that you preferred a deferred profit-sharing plan because the tax benefits were very attractive. Now, if cash partnership pay plans received similar tax benefits, do you think you and other firms would also be very interested in that kind of arrangement?

Mr. WIMPFHEIMER. Well, I do have a cash plan and the answer is yes.

Chairman WYDEN. Fair enough.

Mr. WIMPFHEIMER. We have a 401 also. So, we're not so far from being able to do these things.

Chairman WYDEN. Good, excellent.

Mr. WIMPFHEIMER. But I'd like to go back—it really should be the choice of the individual. If it was totally deferred, the profit sharing, and you gave them a choice each year to take a portion or the total amount in cash if they needed it, that would solve the problem.

Chairman WYDEN. It also solves another very important problem in that it probably minimizes revenue that would be lost. Of course, these taxes don't just kind of fall out of the sky. They're your money, money that you send to Washington, DC when you have this delightful experience of filling out your 1040 form each year. Tax breaks are things that must be examined very carefully to assess the cost effectiveness. Your suggestion is a very practical one.

Mr. WIMPFHEIMER. When we started profit sharing, I think taxes took about 85 percent of our profit. This was right after the war. But during the war years there were excess profit taxes. Actually, the government was paying most of our profit sharing. Now that was an incentive to put in a program in those days. Now, David, I don't know how many of those companies still exist, but that beginning group of people who started it were zealots.

Chairman WYDEN. Well, let's get Mr. Wray into this debate. Your organization, Mr. Wray, has focused on essentially the plans, the employee partnership plans that center around profits. Is there any reason in your mind that firms couldn't achieve the same sort of goals, such as increasing productivity, if they centered their pay plans on other goals such as sales or reducing costs or something like that?

Mr. WRAY. I think the key principle to understand is that American business is very diverse, and that their employee work forces are very diverse, and that each company in its unique needs, needs to put together its own package that will work for it. So, combinations of different approaches, or a different approach in one company and another, is certainly possible.

So if you want to tie profit sharing to sales increases or other kinds of things, all of these have worked. There's a wide range out there in how you determine the pool, again, and profit is not always the way it's done. Companies have used other targets, if you will, and been successful.

But again, the key here is really the corporate culture and the philosophy in the organization. The company has to know itself so that it puts together the right program. But the key is the commitment to the philosophy.

Chairman WYDEN. In terms of the barriers, and given the fact that you have been out there looking at this issue for a long time, what do you think are the major barriers that keep the numbers, as you said in your testimony, pretty modest in terms of firms adopting this kind of system?

Mr. WRAY. In publicly traded companies, the issues that Jack raised are very prevalent. There are a lot of stockholders that do not believe that employees should share in the profits. They fundamentally believe that profits are the reward of ownership or investment and that should not be shared. So, it's a philosophical issue.

In private companies, I think it's the corporate culture issue, which is probably the most dramatic. In privately owned companies they can do what they wish, and if they feel that this kind of program will work, they can put it in and it can be very successful. So, it's a combination of those two issues. But the overriding one everywhere is the corporate culture issue.

This takes an open-mindedness about the employment relationship that typically does not exist in American business, and if you don't have that open-mindedness, you're not going to look very satisfactorily at these kind of plans. Clearly people who are highly financial in their orientation and who look hard at bottom line numbers every single month, and are trying to squeeze every inch of profit out in the short-term have a hard time connecting up with this long-term human relations commitment, which really is what the corporate culture that is profit sharing is all about.

Chairman WYDEN. If you could wave your wand and tell the government, here is what I think would best encourage other businesses for doing this kind of thing, what would—what would you push your wand toward?

Mr. WRAY. Well, I think there's two issues. One is, I think you have to interest the companies. I know in other countries most of the incentives have been tailored on making the profit-sharing payment more profitable to the employees by reducing taxes for them. But if the employer gets a straight deduction, whether they pay a cash profit-sharing bonus or whether they pay a deferred profit-sharing bonus or whether they buy a piece of computer equipment or whatever, they're going to sit down and they're going to look at things all the same.

So I think that you need to figure out some way to interest the company to make this different kind of allocation of resources, because this is a resource allocation issue.

The second thing is I think that we need a lot more information and dissemination of information about how successful these plans are. I think that having some sort of participation by the government in helping collect and disseminate information on these and best practices of these kinds of plans would help.

I think there are a lot of companies out there that are looking right now for ways to be more competitive. It's a very tough business world out there. Anybody who can get an edge is going to take it. There are many companies in the Profit Sharing Council who believe that profit sharing is their competitive edge. So, I think if we could highlight and illustrate that more effectively, more companies would also participate.

Chairman WYDEN. So part of this is dealing with the corporate culture that has been slow to pick up on the value of it, and part of it is that they can't necessarily easily find information——

Mr. WRAY. Right.

Chairman WYDEN [continuing]. on how to do it. Then I gather you think companies might also be interested in extra deduction or a credit, if the Government so deemed, for profit-sharing arrangements?

Mr. WRAY. It would get their attention. Even if they didn't adopt profit sharing they would all look at it. If the Government said we're going to give a little bit of an incentive, people would then look at it, whereas if you don't do that, they're not going to look at it. Once they look at it and they start evaluating, maybe they'll make the right choice.

Chairman WYDEN. Well said.

Mr. Rezendes, one point for you, if I might. We are going to work very closely with the AFL–CIO and with labor organizations on these issues. That is the way we conduct our business and feel they play a very important role in our society.

As you might guess, the AFL–CIO has a number of reservations about this concept. They have generally been somewhat skeptical of the idea of any kind of variated pay on the basis of this kind of thing. I guess your message today is that for workers, properly done, this can work. For workers who are at the table, literally as I gather you do, every morning, aware on every facet of what is going on, this can really make a difference. Is that correct?

Mr. REZENDES. Yes. I think what your problem is, is that the union doesn't understand which direction you're going. I—until you—two of you people understand one another, you're not going to get anywhere with them. It's just like if I don't understand what the company's trying to do, until they can show me which direction they're going, I'm not going to listen. If it's something that's going to affect my workers we've got to sit down and make sure we all understand what is going on.

If you read my testimony here, I stated this is not something you can shove down people's throat and expect them to understand what you're doing. You have to find people who can go to the people, explain it to them, get their pros and con, go back, talk it over with management, go back down. It's tedious, but it has to be done.

You have to understand which direction everybody's coming from. You have to understand what the workers are looking for, and the workers have to understand what management is looking for. Once you can get a group together and work on it, then you can take it to the people. Then your plan should go through.

Chairman WYDEN. Well, you really sum it up. Nobody ever said change was going to be easy, number one.

Mr. REZENDES. God knows. I've only been president for 2 years.

Chairman WYDEN. Particularly in this kind of arena, what you are looking at is breaking through a lot of the old stereotypes.

Mr. REZENDES. They've got to have trust in you. If they think you're out to give them the shaft, you're done for.

Chairman WYDEN. Yeah. Well, in that sense, that's true about just about everybody's field, whether it's serving in the U.S. Congress or running your union or Mr. Wimpfheimer running his operation.

Mr. REZENDES. Well, I think that's what makes a difference with the Wimpfheimer and the union, is that there's always been trust there, there's always been an openness. If he doesn't like something that the union is doing or if the union doesn't like something the company is doing, we tell one another. We might get upset and not—and go different directions for a couple of days, but then we'll come back and discuss what our problem is once we can think about what one another had said. I think this is where your problem might be. You're not explaining yourself to the union so that they understand what you're saying.

Chairman WYDEN. Well, your testimony has been excellent. To tell you the truth, I hope as this dialogue goes on in Washington, DC, we'll see that some of the same sort of relations develop between labor and management that have developed between you and Mr. Wimpfheimer and the people at Oregon Steel.

We'll have encouragement for entrepreneurials, like my constituent, Mr. Wenner, who is doing great work in Oregon and looking to try to do more and get the President eating his garden burgers, I guess, if that's on this afternoon's program.

Mr. Wray, with your leadership and the work that you have done at the council, giving us guidance and technical information, I think we can get there. I want you to know, I am very, very much committed to getting this done. I was committed to it before, but you have really said it so very well. It's too bad we don't have 535 Members of Congress hanging from the rafters to hear from you.

Mr. REZENDES. It's funny you said that you're committed. Mr. Wimpfheimer was saying in the plane, I wonder how far they're going to go with this. There's your answer.

Chairman WYDEN. People who know me say I am a fairly determined character. So, we'll be looking forward to staying at this and staying at it in conjunction with working with you. So, thank you for the excellent testimony. If you don't have anything further to add, we'll excuse you at this time, and we'll be anxious to be in touch with you.

Mr. WIMPFHEIMER. I can tell you one little thing, possibly, this brings out what Tommy was saying, that the first year that my father offered profit sharing, the union wouldn't accept it, and our local union wouldn't accept it. I think they literally thought it was

some trick to management's advantage, they were so unbelieving. The second year, he said, well, if you'll give me a 3-year contract, I'll give you retroactive the profit sharing you earned last year. From then on, it flew.

Chairman WYDEN. Building trust is what it's about, and generating change doesn't happen with the snap of fingers. You were a terrific panel. I thank you all very much, and you really helped us launch our hearings just as I had hoped. We'll excuse you at this time.

Chairman WYDEN. Our next panel, Mr. John Zalusky, head of Office of Wages and Industrial Relation, AFL–CIO; Professor Doug Kruse, School of Management and Labor Relations, Rutgers; Mr. Jerry McAdams, director, Consortium of Alternative Reward Strategies, Fenton, Michigan; and Professor Daniel Mitchell, John E. Anderson School of Management, UCLA, Los Angeles.

If you four will come forward, we'll get you sworn in. All right. Let us see who we have. We have Mr. Mitchell, we welcome him, Professor Mitchell; and Mr. Kruse, Dr. Kruse, we welcome him; and Mr. McAdams.

Do we have Mr. Zalusky? Welcome, very nice to see you.

All right. Gentlemen, it is the practice of our subcommittee to swear all witnesses. Do any of you have any objection to being sworn? If you would, please raise your right hand.

[Witnesses sworn.]

Chairman WYDEN. Gentlemen, welcome. We'll make your prepared remarks a part of the hearing record in their entirety. As I've been trying to say this morning, it's got a real nice feel to this hearing overall. Just talk to us for a bit, we'll make your prepared remarks a part of the hearing record.

Why don't we, if we might, trying to keep this in some kind of order, why don't we start with Mr. McAdams, and then we'll have Dr. Kruse and then how about Mr. Zalusky and Mr. Mitchell. Is that acceptable to all four of you?

Mr. McAdams, welcome. Please proceed.

TESTIMONY OF JERRY McADAMS, DIRECTOR, CONSORTIUM OF ALTERNATIVE REWARD STRATEGIES, VICE-PRESIDENT, PERFORMANCE IMPROVEMENT RESOURCES, MARITZ INC., FENTON, MICHIGAN

Mr. MCADAMS. Thank you. As I was listening to the panel before, and when you've been doing this for 20 years and spending the last 15 almost on a nonprofit basis trying to study this field, I was making some notes of some things that might help create a context for the discussion. Most of what we heard this morning was anecdotal in nature, which is really powerful kinds of messages.

What I've been concerned about is—anecdotes are wonderful for the kind of involvement in spirit we're trying to create. My interest is to try to figure out some technical background for it. So, the why is what you've been talking about so far. I'm interested in how, and what you get for the money you spend.

That's kind of a fundamental logic of mine. If you want to get the attention and support of a CEO, you grab them by the P&L, their heart and mind will follow. The idea is we're trying to figure

out how we get everybody engaged in this process in the most positive manner.

Just to let you know the director of a nonprofit organization, which is what I do in my spare time. The Consortium of Alternative Reward Strategies research is called CARS for short. My day job is I am a divisional vice president of Maritz, Inc., in St. Louis, Missouri. We're a privately held company, $1.4 billion. We are in the travel, marketing research and performance improvement turnkey business.

I've been involved in this field for about 20 years. I served on the White House Conference on Productivity in 1984, and have been a coauthor for the three largest studies in this area published for general consumption, all nonprofit efforts.

The CARS research, which is what I'd like to address and share with you, is not limited to cash profit sharing at all. We've actually analyzed a variety of what we call performance reward plans. They, both how they're structured as well as their benefits, fall under this broad category of what's the benefits to the organization and the employee. They do fall in this general category of employee organizational partnership plans.

Two things you might want to consider. One is the word "pay" brings an awful lot of agenda with it. We use the word "reward" and we use it because it can often cover a variety of things, and they are not necessarily cash. I really can't address what the effect is on the economy as a whole. These gentlemen are experts on that, except to the point that better business and better rewards for employees is probably going to improve the economy. I don't want to tell you more than you want to know about all of this.

We have a 400-page document that is being published as we speak. It's called Organization Performance Reward, it's the result of our research, 663 cases analyzed over a period of 4 years. It's published by the American Compensation Association and we would be delighted to send you a copy of it if you are an insomniac and would like to have something to read.

Chairman WYDEN. We would like to see it.

[The information may be found in the appendix.]

Mr. MCADAMS. But we're proud of it because it's all done out of the really goodwill of the people who have worked on it. These plans, we have found, are clearly an opportunity for performance improvement through people. There are lots of ways to improve performance, but through people is the primary issue.

But as you've heard this morning, all of these efforts require a pragmatic support, goodwill, and money on all involved. Depending on the plan design—and that's probably a critical issue—they can provide a healthy return to the organization, and this is probably the most interesting part of our research. But there is a subtle and a critical point here. We differentiate these plans from pay. We differentiate these plans from compensation programs.

The vast majority of these plans are in addition to the existing base pay process. They are designed to improve organizational performance through people, but are earned in every period. Therefore, they cannot become entitlements. The argument that was made earlier, don't let profit sharing become an entitlement, to be

expected, is a critical and distinguishing point. These are earned and that's truly the heart of our capitalist environment.

In order to accomplish what we tried to do, we got 80,000 names, we made 66,000 phone calls, talked to 10,000 plans, and winnowed it down to a very definitive scope of our research. I share the scope statement with you not to describe the research, but to make a point that it's a result of what our board of experts worked for 18 months on, to try to determine what it is that would make a plan effective. So, that was a critical distinction for us.

Briefly, these elements are a plan needs to focus on the strategic objectives that are healthy for the organization, whatever those might be. They can be profit, quality, productivity, customer satisfaction, safety, the list goes as long as the strategic objectives of the organization, we believe, and we focused on rewarding rank and file employees.

Managers can be involved, and they certainly can receive the awards, but if it didn't include the rank and file, we did not believe it would have a significant effect on the organization's performance. This is perhaps the most critical distinction. It has to have a preannounced reward formula that links organizational performance and individual reward. The distinction here is that management in our opinion cannot get into the middle of it.

Say there's a pool of money, and Congressman Wyden, you get so much and Chris gets so much, because what it does is, it confuses the employees of who the customer is because you're going to serve the person who controls your wages. The objective is that it's established formula and everybody knows what the name of the game is up front and there's no management interference in that process, critical element, in our opinion, to make these things work.

They generally need to be paid out by a year—by the way, could be the end of the year. The most successful plans are plans that pay out more frequently. The awards are not limited to cash. They can be stock, merchandise, travel, any kind of thing that makes sense to the employees. Our most latest research covered 663 plans and 1.4 million employees. We did not study merit pay, competency-based pay, anything that you would consider to be basic plans.

I'll leave all the definitions of plans and the details of the research to the record. But there are some major findings from this research that I think are particularly germane to you, your investigation. One is we found the plans work in almost all environments.

It didn't make any difference whether it was service, manufacturing, union or nonunion. They all had consistent and correlative statistical valid results. We found it's simply not a union and nonunion issue. We found surprisingly enough that the payouts are very modest. They are not anywhere near like some of the numbers you heard earlier. In fact, the median payout is $867 per employee per year. That's 2.9 percent of base pay of the people included in the study.

We used to think it took from 10 to 30 percent of base pay to get people to make a difference. What we found out is we're paying 10 to 30 percent to get people to work harder, not necessarily to become involved in the system, to make the process better. I mean,

I don't know that we need to make people work harder. The American work force works pretty darn hard as it is. The issue is, how can we get their creativity and their involvement and their intelligence involved in the process?

We find out that when employees are involved as a valued asset, they can make a heck of a difference in an organization. The size of the award is not as important as it is if all you ask them to do is to work harder.

Probably the biggest distinguishing factor in this research is a discussion of gains. The question is: What are you getting for your improvement? If you're going to pay out $867 per employee on a median basis, and some of those payoffs were considerably higher and some were lower, what are you getting back for your money?

What we found is the value of the performance improvement had a median of $2,400, per employee, per year. We found, however, that the plans that could put this dollar value on the gain, were almost always what we call operational plans, measuring productivity, quality, safety, things like that.

We found financial plans, i.e., profit-sharing plans, that almost never put a dollar value on the gain. Why? Because we think it's line of sight; the ability of the individual to relate to a measure that might be as far away as profit to them. It is our feeling that profit-sharing plans, except in small organizations, tend to accrete awareness, but not necessarily a change in behavior. More operational measures on which you reward are closer to the people and they feel like they can influence them more directly.

When you relate a gain and you relate a payout, you have an opportunity to talk about return on investment. Now we are playing the stockholders game, which I think is a critical element of this discussion.

When we talk about, I don't want profit-sharing because I am giving away part of my profits. The assumption is the people didn't do anything to earn those additional profits. But if you can prove you get a return on investment on these plans, you begin to start answering these questions.

The median return on pay out was 134 percent. That means the company earned $2.34 and they paid out $1. That is pretty good—better than what I get in the stock market today. My buy/sell strategy is off right now.

Chairman WYDEN. If I might, if you could highlight some of your remaining concerns.

Mr. MCADAMS. Remaining recommendations, I do have some specific things you might be interested in. One, even though this is the Committee on Small Business, these discussions are not constrained by the size of the organization. This applies to all size organizations. It is not limited to small.

The first recommendation is, unlike traditional compensation plans which pay for doing a job and not necessarily how well it is done, performance reward plans only reward when there is an indicator of an organization's performance improvement. That contributes to improved economy and job stability.

It would be appropriate, in my opinion, to provide tax incentives to both the organization and the employee based on rewards of cash and noncash earned. That would encourage more organiza-

tions to implement them. But we have to define the rules and regulations pretty carefully.

Second, if you can't do that, the new tax law requires a 28 percent withholding on any bonuses except on lower-paid employees. That gives the perception that these plans are more expensive than they really are. Many of these plans pay a portion of the taxes to make it more positive for the employee. When you have a higher withholding, it makes it more difficult, moving at least back to the 20 percent would give it more value, not on base wage but on bonuses.

The regulations require that any bonus payments have to go into base pay for the calculation of overtime. That makes all these plans considerably more expensive. Rescinding that rule would make a difference.

The recent NLRB regulations tend to restrict the opportunity for groups of employees to work together on performance improvement efforts, exactly the key of what the whole panel has been talking about, employee involvement to make a difference. These rules are clearly counterproductive. In our opinion they do little to encourage labor.

Finally, the government could be a role model for these plans and putting them in appropriate departments. We are already being contacted by a variety of organizations.

The traditional pay plans clearly need to be improved but the red tape and civil service regulations will probably slow down that process well beyond my years. Performance improvement plans for the Government could reduce cost, improve productivity and quality and focus on customer satisfaction. These are all the things alluded to in the Vice President's effort toward reinventing Government.

If anything could help in the design or process of this, please call us to help in this effort.

Thank you.

[Mr. McAdams' statement may be found in the appendix.]

Chairman WYDEN. Thank you very much.

You have been at it for a lot of years. We appreciate your interest and we are going to be anxious to work with you.

I also like your point on how this is not a question of telling people they are supposed to work harder. A vast majority of people in this country go home at the end of the day, and there is no question their body tells them they work plenty hard. The question is, can we provide some incentives to do it. That is what we are going to be working on.

All right. Let us move next to Professor Kruse. Welcome.

TESTIMONY OF DOUG KRUSE, ASSOCIATE PROFESSOR OF HUMAN RELATIONS, SCHOOL OF MANAGEMENT AND LABOR RELATIONS, RUTGERS UNIVERSITY

Dr. KRUSE. Thank you. Thank you for inviting my testimony here.

Like Jerry, I am very impressed by the stories we have heard this morning, stories in individual companies. I think those are tremendously valuable. My own expertise is in doing a number of

studies across organizations. I would like to talk a little about that today.

There are two potential effects of profit-sharing that have attracted a lot of attention. One of these is the potential effect on productivity and performance. We have heard a lot about that. The other is the potential effect of profit-sharing on economic stability, both for individual firms and the economy as a whole, through decreasing layoffs and increasing incentives to hire unemployed workers.

My purpose today is to provide a real quick outline of the research on both of these effects, just hit some of the high points, and then summarize some of the policy implications. More detail is in my written testimony. Much more detail is in the book I recently authored, "Profit-sharing: Does It Make a Difference?" I tried to summarize all the studies that have been done on profit-sharing and add some new evidence here.

Just as a brief aside, 1 week after I signed the book contract to write this book, I was plowed into by a drunk driver going 100 miles an hour, putting me in the hospital for 6 months and then into this wheelchair. In retrospect, maybe I should have realized that someone, somewhere did not want me writing this book. But I went ahead and wrote it anyway.

I should also note that I am actually not getting any royalties off this book. Given the title I probably should have negotiated some kind of profit-sharing arrangement on this book.

First, what are the productivity effects of profit-sharing? There has been 30 careful econometric studies that have tried to separate out the influence of profit-sharing from other factors. These studies are briefly summarized at the back of my written testimony. They are based on actual performance data, not just employer opinions, from over 7,000 companies, from a wide variety of industries in a number of countries.

The results are striking. Of over 300 estimates, almost all are positive, and far more are strongly positive than would be expected if there were no relation. The estimated productivity differentials varied quite a bit with an average of 4.5 percent higher productivity, most estimates in the 3 to 11 percent range.

So there is little doubt of a positive relation. But that of course could simply mean high-productivity firms are more likely to adopt profit-sharing.

I and a couple of other researchers have sought to address this by looking at firms before and after the adoption of profit-sharing, comparing them to their industry peers. My most recent study, reported in the book, found that profit-sharing adopters had, on average, productivity jumps of 4 to 5 percent beyond that of their peers.

But the productivity increases were higher for cash plans, interestingly, and plans with larger average profit shares and the payout more closely linked to profits, as we have been talking about here today. The average 4 to 5 percent increases may not sound like much until, as Representative Wyden stressed, you remember that productivity growth has averaged only 1.2 percent per year over the past 20 years.

So, there is ample evidence showing on average a positive relation between profit-sharing and productivity, but clearly there is no

automatic connection. Simply installing a plan won't magically increase productivity. We have heard that several times this morning too. Research has indicated that cash plans and larger profit shares work better but it has been much less successful at establishing what else makes profit-sharing work well, whether and how it should be combined with other firm policies. There is clearly a consensus of opinion, in which I share, that profit-sharing should be combined with other policies like employee involvement to empower employees, and there are a few suggestive results, but there are no clear conclusions on which policies should be used to maximize the likelihood of positive effects.

Next, what are the results on economic stability effects of profit-sharing?

These are based on the share economy theory that received a lot of attention when it was developed by Marty Weitzman of Harvard University about 10 years ago. This theory predicts employers treat profit-sharing plans differently than fixed wages in making employment decisions, and that if part of worker pay comes in the form of a profit share instead of fixed wages, the employer will have more incentive to hire new workers and less to lay workers off. If enough firms in the economy do this, overall unemployment should be lower and the economy should be much less prone to recessions.

Because of these macro benefits, Weitzman proposes that tax incentives are justified. Let me briefly note it makes no difference whether the profit share is cash or deferred under this theory. Also, many people have wrongly concluded the worker's fixed wage must be lower for this theory to work. In fact, the stability theory can work with no decrease in the regular wage if profit-sharing results in higher productivity and gives workers a good profit share. It acts as a cushion against layoffs when times are bad.

What does the empirical research show on this?

It is a much more difficult theory to test, for a variety of reasons. There have been 16 studies of the effects of employee profit-sharing, also summarized at the end of my testimony.

Generally speaking, almost all of the studies directly examining stability effects have found some evidence of more bigger stability for profit-sharing firms. For example, Bob Smith and Jim Chelius did a large survey of small businesses, almost 3,000, and found the profit-sharing ones were less likely to lay off workers when the firm's sales declined.

I mention this study not only because it is of small business and therefore appropriate for this subcommittee, but also because Jim Chelius is my department chair.

Most of these studies find evidence of stabilizing effects, but there are a number of estimates where the possibility of no effects cannot be rejected. In itself this is not necessarily at odds with theory, since stabilizing effects are not predicted in every instance and the theory is very tricky to test. The evidence rarely points in one direction on important policy issues, even on straightforward economic applications such as the employment effects of a minimum wage, as Dan Mitchell points out in his written testimony. But it is fair to say we are not as confident profit-sharing is related to stability as we are that it is related to productivity.

So what are the policy implications? As I discuss in my written statement, there is clearly a case for an information collection and dissemination program by government to get the word out, get companies to take notice of this. The research indicates that profit-sharing may play a role in both productivity and employment stability.

As for tax incentives, deferred profit-sharing plans, like ESOP's, already receive favorable treatment as a form of pension plan, so the case is strongest to fashion some similar form of favorable treatment for cash plans.

If this is done, favorable treatment should be given to plans, first, where the payments are explicitly tied to some measure of firm performance, not necessarily just profits but any measure that somehow reflects demand for the firm's products; and second, where the average profit share is a substantial portion of employee pay, at least 5 percent and preferably at least 10 percent. The positive effects on productivity and stability are much more likely when the profit share is larger.

So in conclusion, it is clear we are dealing with real big-ticket economic issues here—productivity, unemployment, macroeconomic stability, very big issues. In this case, I think that both the theory and research make a real case for increased Government attention and promotion on profit-sharing and gain-sharing plans.

Thank you for the opportunity to have some input here.

[Dr. Kruse's statement may be found in the appendix.]

Chairman WYDEN. Professor, well said. We will have some questions in a moment. I was interested in the way you noted that you mention your colleague's studies, because it is sort of a profit-sharing kind of approach as well. They are involved in setting your salary. I will take note of that.

Mr. Zalusky, welcome. Please proceed as you choose.

TESTIMONY OF JOHN ZALUSKY, HEAD OF OFFICE OF WAGES AND INDUSTRIAL RELATION, AFL–CIO

Mr. ZALUSKY. It is a pleasure to be here, Congressman. I get to see some of my old friends. We travel the same circuit quite a bit.

The AFL–CIO has never opposed profit-sharing, gain-sharing systems or any other form of flexible compensation. In fact, some of the early piecework systems were negotiated between the needle trades industry unions and industry people. The real issue there was really whether there would be collective bargaining, whether there was participation in the process.

This has been going on for decades. As you may know, the United Auto Workers first proposed profit-sharing in the auto industry in the late 1940's and early 1950's. It was described then as a Socialist-Communist conspiracy by the Ford family, and there was a lot of hard language applied to the union's position.

Nevertheless, it did eventually materialize. Chrysler adopted profit-sharing as a part of the 1979 bail-out activity. Later, the union negotiated it out of the package because the Canadian brothers did not want our Congress dictating to Canadians what to put in their labor contracts. In the meantime, Ford and General Motors negotiated profit-sharing and then Chrysler renegotiated profit-sharing.

In that industry, it has a very specific purpose. Profit sharing is used to stabilize wages across the industry to tax the more profitable firm while maintaining a basic level of wages in the other firms.

Unions have also negotiated gain-sharing plans, and quite successfully. The steelworkers have used gain-sharing extensively. As a matter of fact, Scanlon, famous for the Scanlon plan, was a Steelworker member and later a full time national union representative. The Scanlon plan was first a productivity improvement plan that later became a gain-sharing system following a WWII labor board ruling.

Profit-sharing and gain-sharing can be designed to look an awful lot alike. If you take a multiple factor Scanlon gain-sharing plan and put enough factors in it, the plan can look very much like a profit-sharing plan. In fact, the profit-sharing plan at McDonnell Douglas is called a gain-sharing plan. So, it is hard to lable exactly what we are talking about.

The cash profit-sharing plan has been suggested as a tax encouraged program here. I believe it has some real disadvantages, one of which is it is likely to be pro-cyclical. I mean that in economic terms. As a Nation, if we has wide usage of cash profit-sharing, with cash being distributed to workers in good times it would be viewed almost as though it were discretionary money. The flow into the economic system would come very quickly. This would occur exactly when we were trying to cool down the economic system and exactly when we would want to avoid inflationary pressures. You would have a lot of cash chasing very few goods.

On the contrary, when Congress should be trying to stimulate the economy to provide more jobs on a macro level, there would have less money flowing into it. Low profit-sharing would then be a drag on the system, slowing the economy down, and slowing down growth.

So the AFL–CIO thinks that cash profit sharing is a real disadvantage from a macro point of view. The same thing doesn't happen with gains-sharing, nor with a deferred type of profit-sharing program.

The other problem with cash-sharing types of plans is the linkage between what one does today and the result at the end of the year or even 18 months later when profits are finally determined. Some profit-sharing plans have been designed to bridge this problem by using credits and estimates so that it can be paid quarterly. That sometimes works.

I think American Velvet witnesses made a very good point with the fact that they make a day-to-day connection between plans and profit-sharing every morning. They get in there and talk about what is going on and its relations to profit-sharing. This does not happin with most profit-sharing plans. There is real worker participation, there is real union participation, real legitimacy to the rule of workers. It is very much a marriage between labor and management and they do it through profit-sharing.

You heard about the response when there were no profits. That is exactly what Paul Allaire of the Xerox and the President of Polaroid were concerned about. Sometimes with profit-sharing it can be nobody's fault and profits go down. Or sometimes it may be the

CEO's mistake—they made an Edsel or they decided to produce a new Coca-Cola and profits go down. Employees then are really very angry with management's poor decisions that affect profit-sharing. There can be a dysfunctional relationship as a result, a little bit like a marriage partner cheating. The lack of trust can go on for a long time after management makes a mistake.

So there are some really bad sides to cash profit-sharing. That is exactly what the colloquy between the CEO of Polaroid and Paul Allaire of Xerox were talking about at the Dunlop hearings in Boston.

Finally, I think another point on profit-sharing is that profits can be manipulated and that presents a good deal of concern, whether it is real or imagined. As you have heard, the union representative speaking with regard to American Velvet, there is a strong element of trust and faith, and that bridges a lot of discomfort that takes place. They struggle with this each day and go through the books on a regular basis.

Very often that does not happen where there is no union. Profits are determined by management on whatever basis they choose. If Congress has any questions about the fidelity of management with regard to profit-sharing simply look at the Department of Labor's enforcement activity with regard to ERISA and defered profit-sharing plans. There are an enormous amount of enforcement problems that take place in this area.

With regard to the employment problem, when Marty Weitzman first came up with his proposal on profit-sharing, as a national employment policy, we surveyed our local unions. We have 42,000 local unions out there. We found a few that had profit-sharing plans where profit-sharing was a large share of compensation, about 50 percent.

When we checked and spoke to these folks, one that really comes to mind is Michigan Wheel in upstate Michigan. It produces the huge propellers for ships. The experience there was—and this is a small community—that the people who were in the union and the management team liked the level of compensation they were getting with their profit sharing plans.

So when profits decreased, the normal reaction was to retain this level of income. They did this by quck and deep layoffs. They needed money paid as profit-sharing. They had to pay the power company mortgage holders. The lenders would not wait for improvement in company profits.

So even in that small community, where everybody was related to one another, the layoffs of the newer people occurred quickly and harshly. They were fast to lay off because they wanted to maintain the income level based on profit-sharing. When conditions improved, they were very reluctant to bring new people on because they weren't quite sure whether profit stability would be there in the future. We found a couple of examples like this but Michigan Wheel is the one that really comes to mind.

So I really question whether the positive employment effects are there with profit-sharing. It has not been our experience though the theory looks good.

The other concern I have is one that your aid Chris shared with me, the outline of some of your thoughts on a tax incentive for prof-

it-sharing—the observation that if only 10 million workers were to benefit from tax incentives and each were to get a $1,000 per year tax savings, that would be $2 billion a year of taxes forgone by the Government; $10 billion over 5 years. I doubt that we would find that kind of productivity improvement and kind of tax savings coming back to Government from this profit-sharing tax incentive.

I have never seen any studies that would support that. So, I think the committee must find that profit-sharing tax cuts are somehow going to balance out. Costs balance with new income to government.

Congress, under its own rules, also requires that if Congress is going to spend taxes, one has to have other programs to cut or taxes must be increased. I think Congress would be quite reluctant to increase taxes for a national profit-sharing plan. So, I am very concerned about where the program cuts might come.

We have had a wide range of other experiences with other variable compensation plans. I would mention that the employee stock ownership plans do get some tax incentive; they are relatively modest, which are not enough to offset the above cost. There is a 50 percent tax deduction to the bank for the interest that they earn on a loan for an ESOP. That is barely enough to get the transaction going and probably shaves about a quarter of a point off the interest rate.

There is a need for some help in the employee ownership area because the State programs that support worker buyouts are broke. These State programs very often help small businesses make the ownership that our friend from American Velvet wants to make, what he was describing as his capital gains problem. Very often an employee buyout with an ESOP is a way for a sole owner to sell the business.

Having said that, I will conclude my remarks and stand ready to answer your questions.

[Mr. Zalusky's statement may be found in the appendix.]

Chairman WYDEN. Very good. We will have some in a moment. We thank you.

Professor Mitchell.

TESTIMONY OF DANIEL MITCHELL, JOHN E. ANDERSON SCHOOL OF MANAGEMENT, UCLA, LOS ANGELES

Mr. MITCHELL. Thank you, Mr. Chairman.

When Moses came down from the mountain, he had 10 points to give to the people. So, I have to set that as an absolute limit. So, I am going to keep my points well below that level.

My first point is that profit and gain-sharing should be encouraged because of the potential macroeconomic effects that they have in stabilizing and possibly expanding employment. In terms of the productivity effects, which Doug Kruse spoke about, I think those are real. But they by themselves don't provide a rationale for tax subsidization, because if companies feel that the plans will more than pay for themselves, then that is what has to happen; they will install such plans.

The second point is that favorable tax treatment should be provided only to plans which provide explicit formulas that link pay to profit, or revenue, or some other value measure, and which put

a significant fraction of pay at risk, say, 10 to 30 percent, the kind of numbers we were hearing from American Velvet, that you cited on Lincoln Electric and so on. Currently, plans which have no formal linkages and plans, whether they are linked or not, which only provide for a small bonus in terms of the total compensation package receive favorable treatment.

Third, favorable tax treatment should not be conditioned on paying bonuses into a deferred retirement fund. Cash plans should be equally eligible. The macro effects come from the variability of the bonus and not the use to which the bonus may be put.

Fourth, the employee stock ownership plans, or ESOP's, do not in general provide the kind of macro benefits that are worthy of public subsidy. The tax expenditures now attributable to ESOP's and to discretionary, that is nonformula profit-sharing plans, should be redirected to genuine profit and gain-sharing plans.

Since there are, in fact, as John points out, some tight restraints on the budget, I think the best you can hope to do is to retarget the existing tax expenditures to those plans that have the desirable effects.

Fifth, there is a case for a Government provision of information regarding alternative pay plans, provided it is done in a neutral and accurate fashion. Now, there is a substantial amount of private information available to employers. I don't think you can say that the lack of use of profit and gain-sharing comes because employers have never heard of such plans. So, what we are talking about is quality of information rather than quantity of information.

Sixth and related, basic consistent Government data on the incidence, the use of profit-sharing, gain-sharing, and ESOP's are currently quite limited, and could be much improved. If you just want to know how many people are covered by these plans, you can get wildly differing estimates depending on who you go to. The Bureau of Labor Statistics should be the source of definitive information on all of these plans, but I am sorry to say that is not currently the case.

In addition, the Office of Management and Budget, when it estimates total tax expenditures, tends to lump ESOP's and deferred profit-sharing in with all kinds of other pension plans, and so it is all blended into a large total number. We really need to have that information separately.

Seventh and my last point relates to the Dunlop Commission I think John referred to. The Dunlop Commission almost totally neglected pay systems in its recent interim report on worker-management relations. You will find a couple of paragraphs on ESOP's, nothing on profit-sharing or gain-sharing. Those should have been major topics to be included in that commission report, and certainly should be part of the commission's final recommendation. So, anything that can be done to encourage the Dunlop Commission to refocus its efforts I think would be important.

I will make one last point that goes perhaps somewhat contrary to my interest as an academic. We academics always like to say, Well, this is a topic on which we really need some more research, more empirical studies, and so on. But I think, as Doug showed you, he has got a book here that pretty well summarizes the field. I think we could go another 10 years with more studies and we

would pretty well come to about the same conclusions that Doug has already provided for us here at this hearing, and to the reading public generally. So, I think at this point we know about all we can hope to know about profit-sharing and gain-sharing, and it is now really time to get some action.

Thank you, Mr. Chairman.

[Mr. Mitchell's statement may be found in the appendix.]

Chairman WYDEN. Well said. Seven points. That is three less than you promised. We thank you.

All of you have been excellent. Why don't I start with you, Professor Mitchell, and ask you a few questions. Maybe we will just try to get everybody into the act here.

Even though there are over 8 million Americans who are unemployed or too discouraged to even look for work, inflation fears are bumping up the interest rates and slowing down the rate of job creation. Do you think the employee partnership pay can lead us beyond this kind of cruel cycle and toward a more productive country?

Mr. MITCHELL. I am reminded of remarks that were made about a decade ago by Lee Iacocca, CEO of Chrysler at the time. He said that when people look back at this era in terms of our anti-inflation policies, they will probably compare them to bloodletting in the Middle Ages. That is the way our current anti-inflation policy operates. We just slow down the economy, even if we are not really sure there is very much inflation out there, and in doing that we incur the risk of increased unemployment, decreased employment, and all of the problems that go with that.

I think you would have to say that in terms of new ideas for macroeconomic stabilization and employment expansion, really profit-sharing and gain-sharing, what you are calling partnership plans, are the only new idea on the table.

So if we don't go in that direction, we are just back in the old rut that we seem to be repeating right now.

Chairman WYDEN. How exactly does employee partnership pay help firms to become more competitive?

Mr. MITCHELL. Well, there are a variety of mechanisms but I think one element that came up in the previous panel is of course the increased productivity effect. As Doug mentioned, there is a considerable body of empirical evidence that suggests that those effects are real. So, that certainly is one element in competitiveness.

But I think there is another important side, and that is that there is a kind of a buffer effect that comes from these plans. A number of our spokespersons earlier referred to the fact that when business conditions become adverse, the bonus can shrink a little bit and you can maintain employment.

I guess I have a bit of a difference with John Zalusky on this.

Chairman WYDEN. I am going to get you all agreeing before the end of the morning. Don't worry about that.

Mr. MITCHELL. Well, we have got negotiators here. But I do think that keeping people on the job, keeping them employed, is an important function that the plans can have. There was some discussion about the word bonus and what that means.

I think there has actually been some psychological research on how people conceive bonuses. When you tell them a certain part of

your compensation is a bonus and a certain part is a wage they do think of it differently and they do think of the bonus as perhaps being more temporary, more uncertain, more transitory.

So I am not sure that people will just spend the money as if it is part of their fixed wage and then suddenly be surprised when there is a bad year and that money goes away. I think they will treat it somewhat differently and modify their consumption plans in accordance with the fact that the bonus is a variable and uncertain element.

Chairman WYDEN. Let me ask you something about your research and sort of the sums of money that might be involved here. I understand that on the basis of your research you have indicated that decreasing the unemployment rate by 1 percent could add about $120 billion to our economy.

Now, if partnership pay could lower unemployment even by a quarter of a percent, that seems to me to be a $30 billion net plus for our economy. Is that a possibility?

Mr. MITCHELL. I think it is. We have got such a large economy that even shaving a few tenths of a point off the unemployment rate makes a big absolute dollar contribution.

Chairman WYDEN. Now, Mr. Zalusky is concerned about some of these issues with respect to the business cycle and the like. I want to try to bring these two points of view together. What would you say could resolve this kind of contrary view?

Obviously, we saw the heart of it with Mr. Rezendes and Mr. Wimpfheimer out there in the real world. This is going to talk about building trust. Maybe we have to write a bill that say everybody has to get together every morning, and you know, of course it is ridiculous.

But how do we try to reconcile these two views and try to come up with something that will really allow the Federal Government to target its resources, and yet promote this on a voluntary basis? I think Mr. Zalusky knows and has talked to the staff about it. We are not talking about mandating anything here. Nobody is going to be required to do anything. Let me just reaffirm that.

We are talking about whether we can come up with something that is voluntary and attractive so that across the country we get workers and managers to essentially build this kind of thing we saw with Mr. Rezendes and Mr. Wimpfheimer.

Professor Mitchell, what is your sense about how we resolve the different views on this?

Mr. MITCHELL. Perhaps somewhat paradoxically, I think the union sector is somewhat better positioned to deal with some of the problems that might come up in terms of monitoring the profit-sharing or gain-sharing kinds of arrangements. That is precisely because you can negotiate a contract or just simply because you have a good relationship, as apparently was the case at American Velvet. You can arrange to have a look at the books, have outside auditors come in, if that is what is required, do what you need to do so that there isn't the chiseling and cheating as there could conceivably be in terms of determining what the profit base is.

If I am not incorrect, I believe that when the Ford and GM plans were negotiated originally in 1982, there were explicit contractual arrangements made for auditing and for defining exactly how prof-

its would be determined. So, the workers under those plans perhaps have a better assurance than many other workers that the plans are being operated honestly and fairly and in accordance with the formulas that have been determined.

Chairman WYDEN. Now, the tax laws today offer the benefits for deferred profit-sharing plans, and people down the road are going to get them. In your view, is there any advantage to those plans over cash employee partnership plans?

Mr. MITCHELL. No, I would say in fact, there might be a case for the reverse. The reason that the deferred plans get the tax credit is they are viewed analogously to pensions. But if you think of a typical pension arrangement, you have a defined benefit plan in which the actual annuity that you are going to receive is going to be determined on such things as your age and your service and what your final earnings were and so on. So, it is a kind of a guarantee to you.

Or you have defined contribution plans of a variety of types in which the money is placed in a broad portfolio of assets, and although there is some risk as to exactly what those assets will translate to when you get to retirement age, because you haven't put all your eggs in one basket, at least you have got a pretty good portfolio to draw on.

Where you have got deferred profit-sharing plans, the assets may effectively end up in just the stock of the one company. They are not necessarily under the same tight restrictions that other forms of profit-sharing are in terms of the investment portfolio.

So I think I would rather see people have the discretion to take the money in cash. A number of speakers pointed to that. I would not want to see the current tendency to favor the deferred plan over the cash plan continued.

Chairman WYDEN. Mr. Zalusky, what is your reaction to what Mr. Mitchell has been saying?

Mr. ZALUSKY. I disagree.

Chairman WYDEN. I suspected that might be the case. Why don't you start by pointing out areas where you do see it additional.

Mr. ZALUSKY. With regard to the defined benefit pension plan and the defined contribution plans, the defined contribution plans are identified as profit-sharing plans as a generic term. It covers a variety of benefit plans.

Their genesis began as profit-sharing back in 1937. Congress held hearings on profit-sharing plans, and they set them up so that businesses could get a tax advantage by providing profit-sharing plans to highly paid members of the organization—the upper levels of management.

Unions began to negotiate on defined contribution profit-sharing pension plans in the 1950's. They were defined as bargainable issues, I think, in 1955. But the unions really didn't want profit-sharing plans as a pension plan. They wanted more security in the pension as people retire. Nevertheless, they were often the first step to a pension.

That is part of the reason behind the tax advantage for these programs. One, management wanted it for itself; two, it provided more flexibility with less risk to management to have this kind of a program. You see them growing today as things get difficult. Fi-

nally, because it was a matter of national policy that people should retire into security. it had nothing to do with the productivity goal so important today. Those are the reasons behind the tax benefit for deferred profit-sharing.

I don't think that one should cast around to find different types of programs to cut in order to add a tax deduction for cash profit-sharing. If it is going to be justified, it has to be justified on its own. I would also caution that one plan may not be attractive to everyone. We have an awful need to encourage better performance in the nonprofit sector, hospitals, research centers, things of this type, and they do not earn profits.

I think any kind of program we develop coming out of this hearing as a flexable compensation program should do a couple of things. It should be generally applicable. Government employees should be able to participate in the program. I agree with Gary quite strongly on that. They are not able to participate in the traditional type of profit-sharing.

Second, it should encourage some form of participation that we heard described today, where workers really participate. I believe that is where the greatest productivity gain comes from within these programs. We have union negotiated ESOP's. For example, the steelworkers require as part of their programs that they have worker teams set up to make productivity gains at the shop floor. This is just as important as money flowing across the top every year or so.

Finally, where unions are involved, we are quite flexible. I have called to your attention the Saturn gain-sharing, profit-sharing programs in my written testimony. At Magna Copper, where the ability of the enterprise to function and compete globally is a function of the price of raw copper on the world market, our compensation system has been designed and negotiated so that wages in general vary with the price of copper.

Additionally, gain-sharing comes on top of this to allow and encourage worker teams to participate in finding creative ways of doing the job better. Magna Copper now has 25 percent of the global market. Not a bad thing for an American enterprise. It is not a huge firm.

Incidentally, Saturn, which is a startup firm—is a General Motors spinoff, and it is profitable now by any measure. It is going to build a car specifically for competition in Japan in the very near future. They have 10 percent of their compensation at risk.

That risk is designed in two ways. One-third of it is related to profits and quality of the product they produce. The rest of it is related to the training the workers get on an annual basis. It is the team that decides if the training is adequate. The training portion will begin to decrease and other elements will be added in. It is in this way that the plan is tailored to the needs of this new enterprise. And, it is becoming a world-class competitive automobile manufacturer.

So I argue that one sort of compensation system should not be denigrated and another encouraged. I think that is something that the parties that have something at risk ought to do—not academics. They know what the enterprise ought to be able to do through these sorts of compensation programs.

Chairman WYDEN. Well, I think the vast majority of what you have said is not all that inconsistent with what Professor Mitchell has said. There can be some differences in terms of defining the plan, should you use existing resources to also help promote something new.

But the bottom line is that both of you have indicated interest in something that is voluntary. The bottom line is that both of you have indicated interest in something that really gets management and labor together, together early. Both of you believe one size doesn't fit all.

I have got to think that this number that Professor Mitchell talks about just takes your breath away. If employee partnership pay could increase employment by one quarter of 1 percent and add $30 billion to the economy, we would be talking about something that I think could really be of value for the cause we are all interested in, which is more family wage employment.

I think the only other thing I had for you, Mr. Zalusky, is, and maybe you can take this with you and work with Chris and the staff on it, we would be very interested in knowing your thoughts on safeguards, to make sure that firms aren't manipulating plans and calling something a profit when it isn't. My sense is that you all particularly have watched some of the approaches over the years that have been less than ideal, and maybe you could suggest to the staff some safeguards.

Mr. ZALUSKY. I could do that right now, Congressman.

Chairman WYDEN. Well, you just hold forth then.

Mr. ZALUSKY. I think we ought to mandate that everybody have a union, and only those that don't want one would have to vote it out. That way, Congress would have someone there to keep management honest.

Chairman WYDEN. I have a feeling my colleagues will want a little bit more time to reflect on that. But obviously we are interested in working with you. We are interested in your thoughts on safeguards. We see this as something that, if properly done, across the country will launch a lot of the same kinds of discussions. Whether it is collective bargaining or not a unionized shop, they are going to be good for America. That is getting labor and management together, and agreed, as Mr. Rezendes said, everybody loses if you cut a little too much cloth.

We hardly ever get a witness to sum it up in about 2 minutes. I think you all know that what he said is that everybody has a reason in his operation not to cut too much cloth. Everybody at his operation has a reason to see if there is a machine that is starting to go down and starting to cause problems. That is what we want to do here. That is——

Mr. ZALUSKY. Yes, I would be glad to work with Chris.

Chairman WYDEN. We are going to work closely with you in that regard.

Let me ask a couple of other questions. Mr. McAdams and Professor Kruse, both of you were really excellent and hit an awful lot of what I wanted to ask.

Mr. McAdams, why don't we get you to elaborate a little bit on this matter of a successful performance reward plan requiring short line sight, I think as you described it. Does this mean that

cash plans that pay out quarterly or yearly are more effective than deferred plans that only pay out when somebody retires, in your view?

Mr. McADAMS. Yes. The data—we didn't really compare plans that regularly paid out versus those that paid out deferred. We made that a part of the research scope definition.

There is an intuitive sense, however, that particularly with the younger work force changing their behavior to improve performance so you get more money in your retirement plan, while might be positive, I don't know that it is actionable right off the bat. There seems to be a fair amount of information to support that.

Chairman WYDEN. How did the firms you looked at develop these specific performance reward plans that they implemented?

Mr. McADAMS. I think that is a particularly appropriate question considering John and Dan's comment. The key to this is a great, well-designed plan, poorly implemented, will never be as successful as an average designed plan well implemented. Of course, you don't have to settle for poor design. The best plans involve a cross-functional selection of people, representatives from the union, representatives from the nonexempt work force, people from finance, people from MIF.

Because the fact is that the primary strategy of these plans is that we are all in this together. In the 1984 White House Conference on Productivity, we called it common fate. If we are all in this together, we can all share. That means treating people with respect. It means honoring their expertise and their creativity.

The best designed plans, the most effective ones we found, are those that were designed that involved a broad cross-section of people, all the constituencies were represented, returned a good return on investment to the company, and they communicated and involved people in the actual operation and—we call it working the plan. It is getting people together to say, Hey, how can we reduce the amount of cloth we are using. That is the key to these plans.

Chairman WYDEN. The U.S. Congress cannot legislate the kind of trust and respect you are talking about. But we can create some incentives to try to reward people for it. That is what we are going to be looking at.

Let me wrap up with you, Professor Kruse. This subcommittee has been very interested in the well-being of the part-time worker as well, particularly the part-time worker who probably doesn't take home a lot of bucks and probably has pretty meager benefits as well.

The number of these folks has grown vastly over the last decade, as you know. In your view, can the flexibility of employee partnership pay be a way to create incentives for these firms to actually bring on more full-time workers with full benefits?

Mr. KRUSE. That is a good question. Yes, it can be. The macroeconomic benefits of profit-sharing say that this should give employers the incentive to go out and hire new workers.

Marty Weitzman has a wonderful analogy. He says that the share system where you have widespread profit-sharing should make profit-sharing firms like vacuum cleaners on wheels, searching in every nook and cranny for workers to hire. I always liked that image. The idea is that certainly there is an incentive to go

out there and hire the workers, bring them on full-time, to bring workers on as much as possible.

Do firms act like vacuum cleaners on wheels? As I say, there is certainly a number of pieces of evidence that there is more stability in these profit-sharing firms. But whether they are acting like vacuum cleaners, I haven't figured out how to test that one yet.

Chairman WYDEN. But you would say at this point that certainly theoretically, if you have this kind of tool, a tool that was voluntary, one that offered attractive kind of incentives, this would on the basis of the work you have been doing and the writing that you have been doing offer an incentive in theory to employers to bring some folks on full-time as an alternative to part-time, low-wage, low-benefit——

Mr. KRUSE. Oh, yes. There is a very strong theoretical case and there are supportive findings for that theory.

Mr. MCADAMS. Congressman, if I may, one comment about that. In our research we are finding more and more part-time people being engaged in these plans, in being included in these plans.

Chairman WYDEN. That is good. That is encouraging.

Mr. MCADAMS. It used to be that the nonexempt worker was the lowest person on food chain, no one respected their input or involvement. As we are seeing them becoming more involved in the improvement process, the person who seems to be taking that place is the part-time worker, who they think has no brain and no real involvement. That is just not the case.

So to ignore them as an opportunity to get engaged in the process doesn't make any sense either. I think we are going to see in the 21st Century that part-time people are going to be just as engaged in this process as others. I certainly hope so.

Mr. ZALUSKY. We have some of these programs going in the retail food industry, we have a number of part-time workers. Very often you will find the union negotiating their inclusion into the process.

Mr. MITCHELL. If I could add one point, Congressman Wyden, there has been a marked growth in the use of temporary workers of various types in the last few years. One reason that employers have tilted toward temporary employees is in fact, that they are reluctant to be stuck with fixed costs. With a temporary, you use them when you need them and then they are gone and they are no longer on your payroll.

When you have a pay system which has a certain amount of flexibility, you are not stuck with a fixed cost. So, I think more widespread use of profit-sharing, partnership plans, as you call them, would in fact, encourage more full-time, regular employment as a means of sharing risk through the plan rather than the use of temporaries and contingent workers.

Chairman WYDEN. Well, when it all is said and done, what we have to do is cultivate this kind of ethic that we all share in the good times and we all share in the bad times in these kinds of employee partnership arrangements. Because you are creating the proper incentives, there will be a lot more good times, and people will be able to make the game worth the gamble.

It has been an excellent panel. We are going to be working closely with you in the days ahead.

Do any of you desire to add anything further?

Well, we wish you a good weekend all, and the subcommittee is adjourned.

[Whereupon, at 12:50 p.m., the subcommittee was adjourned, subject to the call of the chair.]

APPENDIX

Statement of Honorable Ron Wyden
Subcommittee on Regulation, Business Opportunities and Technology
Hearing on Employee Partnership Pay
July 15, 1994

Today the Small Business Subcommittee on Regulation, Business Opportunities and Technology begins a series of hearings to explore new opportunities for enhancing small business productivity.

Today in America, there is a serious gap between the rate at which our economy grows and the rate at which it produces new, good-paying jobs.

The American Business Conference, a group that speaks for many American firms, recently summed up our challenge by stating that while our economy is growing, the economy is not expanding "at a rate to overcome the hesitancy on the part of most of our firms to add new full-time employees to their payrolls. Even in an otherwise healthy economic environment, vigorous job creation remains an elusive goal."

To meet this challenge, America needs fresh policies that will enable our private sector to create new jobs and enhance small business competitiveness, while permitting productive workers to take home higher pay for their successes.

One potential policy that would reward workers for promoting the economic health of their company is known as "Employee Partnership Pay," and the Subcommittee will examine it today.

Employee Partnership Pay is defined as a pay system in which part of a worker's pay is linked to the achievement of economic goals for the worker's employer. These goals can vary -- from boosting sales, to increasing productivity, to creating more jobs, to raising profits -- depending on the priorities selected. Employee Partnership Pay is grounded in the belief that employees should be partners in the responsibilities, risks, and most important, the rewards of the company they work for.

Let me illustrate how an Employee Partnership Pay plan can work. A small business in Portland, Oregon with 30 employees that produces rubber products for use in heavy trucks might be interested in increasing its sales. Rather than giving employees a regular annual wage increase, the firm could establish an annual wage for each employee they would get regardless of the amount of sales. On top of that, it could establish a Partnership pool that would allow each employee to take home more income based on the firm's achieving a certain sales target. These funds would be distributed to workers annually.

Hypothetically, If the firm had an average year and sales remained the same, the workers total pay would be just as if they got a "normal," annual raise.

But let's say the company had a goal of increasing sales by 10%, and the goal was met. The bonus pool would expand and all the workers would get an even larger Partnership check at the end of the year.

And, if the firm had a really good year and sales went up by 20%, that end-of-year Partnership check would be bigger still.

There would be a direct, immediate correlation between the success of the firm and the size of the workers' bonus.

It should be noted that Employee Partnership Pay has several key differences with other, traditional, tax-favored employee bonus plans. One traditional plan, the stock option, is often available only to high-wage executives. In contrast, Employee Partnership Pay would provide a productivity incentive to <u>all</u> employees.

With another such traditional plan, deferred compensation bonuses, workers don't reap the benefits for 20 or 30 years. In contrast, under Employee Partnership Pay there is an <u>annual</u> connection between results and rewards.

Moreover, Employee Partnership Pay need not be tied just to stock price or profits, it can be tied to any of a number of other financial goals -- revenue growth, productivity increases or gross profit margin.

The evidence indicates that Employee Partnership Pay may provide a way for America to bridge the gap between a growing economy and lagging job creation. By lowering an employer's fixed cost of hiring new workers, Employee Partnership Pay creates an incentive for expanding payrolls -- while also providing a vehicle for making sure workers who produced took home higher paychecks.

The Chair believes that using the Employee Partnership Pay model could be a real shot in the arm to the small business sector. Small business is the backbone of the economy and the engine of job creation. For example, in my home state of Oregon, 95% of firms have fewer than 100 employees, 55% of Oregonians work in small and mid-size firms and 70% of the state's job growth during the 1990s will come from small and mid-size firms.

Small business is especially benefitted by this economic model because Employee Partnership Pay adds real flexibility to a company's operations. Small firms are often cash-strapped, low-margin operations, and by employing Employee Partnership Pay they will be more likely to be able to keep their work force employed through business ups and downs. Employee Partnership Pay is as flexible as it gets -- and can be implemented with little hassle and confusion.

Another potential benefit of Employee Partnership Pay is that it would provide a special incentive for hiring young, entry-level workers. Since the fixed, marginal cost of hiring an additional

worker is reduced, companies will feel there is less risk to adding to their payroll.

The Subcommittee has accumulated evidence showing that in the companies where it has been used, Employee Partnership Pay has boosted productivity by 3% to 5%, which is a huge amount when you consider that average productivity growth for the economy as a whole has been 1.2% over the past 20 years.

Specific examples also show the benefits of Employee Partnership Pay for creating jobs.

For example, Lincoln Electric of Cleveland, Ohio, a leading manufacturer of welding machines, has long been a thriving, profitable enterprise, employing Partnership Pay. Yet, during the devastating 1981-83 recession, when their sales revenues dropped by 40%, **they laid no one off.** It seems they last laid somebody off about 50 years ago.

In addition, in Japan, where about 25% of pay is tied to performance, the unemployment rate has been an incredibly low 3%, even through its recent deep recession.

Raising productivity and creating jobs are the keys to a higher standard of living, and the economic recovery is still not providing adequate job security to American workers.

It seems that Partnership Pay has been so successful because of the emphasis on partnership. When workers have a personal stake in their company, there is an incentive to work smarter and harder. When owners are partners with their workers, they seem less likely to resort to layoffs in bad times.

It is a telling statistic that in Japan, where Partnership Pay is much more prevalent, 93% of the workers feel they will benefit from an increase in the company's productivity, while in America, only 9% of workers feel the same way.

At today's hearing, the Subcommittee will examine the pros and cons of Partnership Pay and consider various proposals to encourage its use. The Chair would like to stress that the Subcommittee is not considering ways to mandate the use of Partnership Pay but rather to make its voluntary adoption more attractive. In addition, the Chair is not in favor of abolishing current tax-favored employee bonus plans.

What the Subcommittee will look at is the potential value of creating new incentives for Employee Partnership Pay arrangements that would enhance productivity.

In this regard, the following questions come to mind:

→ How could incentives be structured so that both management and workers would be interested in adopting Employee

Partnership Pay?

→ How much leeway should companies have in designing the specific goals and rewardsd in their Partnership Pay plans?

→ Are there ways in which management and workers could team up to design the goals and rewards in their plans?

→ What types of safeguards might be needed to prevent companies from manipulating their plans to disadvantage their workers?

Finally, it should be noted that the tax code is currently laden with incentives to encourage companies to boost productivity by replacing workers with machines. In fact, last year such physical investments received $22 billion worth of tax breaks, while investments in workers got just $2 billion.

In today's knowledge-based economy, with concerns about job creation so prevalent, our country can benefit through creative incentives for companies to hire workers. The evidence about the positive effects of Employee Partnership Pay on boosting productivity and non-inflationary economic growth is very promising, and the Subcommittee looks forward to hearing from our witnesses as we examine this issue in detail.

LARRY COMBEST
19TH DISTRICT TEXAS

COMMITTEE ON AGRICULTURE
COMMITTEE ON SMALL BUSINESS
PERMANENT SELECT COMMITTEE ON INTELLIGENCE

ROOM 1511
LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON DC 20515-4319
(202) 225-4005

Congress of the United States
House of Representatives

DISTRICT OFFICES

ROOM 613
FEDERAL BUILDING
LUBBOCK TX 79401
(806) 763-1611

SUITE 205
3800 E 42ND STREET
ODESSA TX 79762
(915) 362-2631

SUITE 205
5809 S WESTERN
AMARILLO TX 79110
(806) 353-3945

SUITE 114
511 W OHIO
MIDLAND TX 79701
(915) 687-0926

OPENING STATEMENT OF THE HONORABLE LARRY COMBEST
TEXAS 19th DISTRICT
HOUSE SMALL BUSINESS SUBCOMMITTEE ON
REGULATION, BUSINESS OPPORTUNITIES, AND TECHNOLOGY

JULY 15, 1994

Mr. Chairman in this mornings hearing we will discuss a number of innovative methods of employee compensation--including cash profit sharing.

In today's global marketplace business leaders know that to be competitive they must have a well trained--highly motivated work force. Businesses have learned that they must compete not only against the store down the street, but often-times with international competitors. This can only be accomplished by adopting new flexible policies that unleash the entrepreneurial spirit of not only managers but all employees.

American business managers have learned that they can tremendously increase quality, worker satisfaction and profitability if they provide workers with a direct stake in the business. By having the employees compensation pegged more directly to reflect the overall performance of the company it gives greater incentives for efficiency and productivity for workers.

We have witnessed a revolutionary change in the American work force. No longer will a majority of workers stay at one business for their entire career. Flexibility and innovative compensation packages will become even more important in recruiting and maintaining high quality workers. This is one of the fundamental reasons I have always opposed big-government, one-sized fits all employee benefit mandates. These mandates are well meaning but simply hold down our entrepreneurs from creating new jobs and new wealth.

I appreciate the Chairman calling this hearing and look forward to working with him to draft initiatives to help spur more innovative compensation plans for small business.

PRESENTATION TO THE SMALL BUSINESS SUB-COMMITTEE WITH REGARDS TO THE ECONOMIC RAMIFICATIONS OF ALTERNATIVE PAY PLANS

(Such as Cash Profit Sharing)

To be presented Friday, July 15, 1994, 10:00 a.m.

Members of the Sub-Committee Staff and Guests:

My name is Paul Wenner and I am CEO and Founder of Wholesome & Hearty Foods, Inc.

Wholesome & Hearty Foods is a Portland, Oregon based company whose stock is traded on the NASDAQ stock exchange and who manufacturers and markets a line of meatless alternative products. I founded the company in 1985 and took it public in 1992, with my executive management team and all the employees of Wholesome & Hearty Foods, we run the company

under a Vision and Values Statement. The Vision and Values Statement was developed by myself and the employees of Wholesome & Hearty, who all desire to run a socially and environmentally conscious business. The company's number one concern was not and is not the bottom line, we all share a belief that fair dealing, honesty and the offering of healthy whole grain earth-wise products would take care of the bottom line. And, as some of you may know, just that has happened. Wholesome & Hearty Foods was the number one growth stock in America last year and has doubled in profits virtually every year since its inception.

I believe that Wholesome & Hearty's success has had much to do with the fact that we are always willing to examine new ideas

and try new business practices. That is why I enthusiastically accepted Congressman Wyden's invitation to speak here today, and encourage all of Congress and the other branches of government to continue looking into alternative business practices which will strengthen American business, not only in its profitability, but in its treatment of people and employees.

But now to the topic that brought us here today: The creation of a profit based compensation plan. I strongly believe that such a compensation method will increase worker productivity. Such compensation packages will give workers what I believe they so desperately need; that is a reason a to do a good job, a reason to care again about what they do and what they make. At Wholesome & Hearty Foods we operate under what is called

TQC or Total Quality Management. In a TQC program, employees are encouraged to examine processes and determine if they are being done to the greatest efficiency or if they can be improved. You would be amazed what savings have been captured by the ideas brought to management's attention by lineworkers and the enthusiasm in which such ideas are given, once it is recognized that management will listen. Workers become more involved not only in their job, but in the entire company, more concerned with its health, more eager to see the company grow. At Wholesome & Hearty Foods every employee from the lowest paid to the highest paid has a common goal, a common belief that they are doing good, that they are offering healthy, environmentally helpful products. That common goal has increased productivity greatly and

created an overall awareness of company dealings. From this awareness comes a sense of ownership, and with this sense of ownership comes better products, more savings and a stronger company. With a stronger company comes a stronger economy and a stronger America. I have recently had employees inquiring into ways to give them more ownership in the company. We have examined ESOPS and other alternative compensation methods and both the management team as well as myself believes that a profit based compensation package would increase the sense of ownership employees have and establish the other benefits that come with that sense of ownership. In addition, I believe that a greater bond between management and labor would be created under such a compensation plan, since both management and employees

compensation would depend upon one another, on increased profits, stability and company strengths.

I also believe that a profit based compensation package would increase employee stability. While it is true that initially there may be some apprehension towards such a compensation package, with employees being unsure as to their wages from pay period to pay period. I believe that they will come to realize there is more stability, due to the fact corporations who adopt such a method will be able to maintain their employees and will not have to lay off employees during economic downswings.

I further believe that the implementing of profit based compensation will begin to accomplish what business means

more than anything right now and that is the creation of a fundamental shift in the way companies do business today. While it is true there are some companies, such as Wholesome & Hearty Foods, who may implement such a plan with or without a tax credit, most companies will need a incentive to try something different. That is why I'm here today, to encourage this Sub-Committee and Congress to allow for tax benefits to companies that implement profit-sharing compensation packages and give the companies a reason to strengthen our economy, give employees a better sense of ownership in what they do, reduce unemployment and strengthen the economy by implementing profit based compensation. Finally, I believe the providing of tax credits for profit based compensation would alleviate to some degree lawsuits which companies who adopt

such policies may face from shareholders under a theory that such pay practices are not legitimate business practices. I encourage all here today to work towards providing companies with alternative business methods, as well as safe havens from the litany of frivolous lawsuits which plague both small and large businesses in this country today.

I would like to thank the Sub-Committee and everyone here today for allowing me to address you. If there are any questions, I would be glad to answer them at this time. Thank you.

OREGON STEEL MILLS

P.O. Box 2760
Portland, Oregon 97208
Phone (503) 286-9651

Date: July 15, 1994
Time: 10:00 a.m.
Place: 2359 Rayburn House Office Building, Washington D.C.

Testimony Before the Small Business Subcommittee on
Regulation, Business, Opportunities, and Technology

Honorable Chairman and Honorable Committee Members,

My name is Burnie Regian. I live in Vancouver, Washington and work for Oregon Steel Mills in Portland, Oregon. I have been employed by Oregon Steel for 5 years and presently Supervise the Employee Involvement Program at the Portland facility. I have worked in this position for 2 years. In my first 3 years of employment, I was an Industrial Electrician in the Plate Rolling Mill. My previous employer was the United States Steel Corporation, Texas Works, Baytown, Texas. I was employed at U.S. Steel for 18 years as an Industrial Electrician. U.S Steel permanently closed the Texas Works plant in 1986.

The central issue on which I wish to speak is **"What are the potential benefits of alternative pay plans for companies, their employees, and the economy as a whole"**. My statements are from my experience in working with two steel companies with two different management styles.

In 1985, Oregon Steel Mills, Portland Division, started a Profit Participation plan for all of their employees. Today, 20% of quarterly profits are paid to employees at OSM's Portland Division. The employees' portion is the percentage payable of 3 months of their basic salary. For example, if an electrician's pay is $3000 per month, $9000 per quarter, and the Profit Participation for that quarter is 30%, the quarterly bonus for that electrician would be $2700. At an average of 30% Profit Participation for the year, the yearly bonus would amount to $10,800 bonus for the electrician and his family. Even though OSM employees enjoy an exceptional benefits package, Profit Participation is regarded by these employees as one of their most outstanding benefits.

What are the potential benefits of alternative pay plans for companies?

Since Oregon Steel has implemented the Profit Participation plan for its employees,

production and quality records have been at an all time high. The morale of it's employees has been enhanced. Sharing in company profits has promoted a feeling of being part of the company, not a piece of the company. Last year, at the OSM Portland plant, a "Cost Awareness" project was initiated by the plant employees. OSM Vice President and General Manager, Portland Steel Works, Joe Corvin explained that out of $1 saved by the elimination of waste and recognized as profit, 20 cents goes directly to the employees as Profit Participation. OSM employees responded to this project by eliminating waste and recognizing $210,000 in savings for the last 4 months of 1993. Increased production and quality, enhanced employee morale, a feeling of belonging, and recognition of costs and waste by employees are potential benefits of alternative pay plans for companies.

What are the potential benefits of alternative pay plans for employees?

Employees privileged to have Profit Sharing as part of their benefit package should never rely on Profit Sharing as part of their regular base pay. Profit Sharing should be recognized as a bonus. This bonus is the biggest potential benefit an employee receives in a Profit Sharing plan. The employee is recognized by the employer as giving extra effort and is compensated for that effort. If there is a down side to Profit Sharing it is that some employees rely on the bonus as part of their regular wage package and a reduction in profits produces little or no bonus.

Job security for employees could be a potential benefit of Profit Sharing. Customarily, in the steel industry, the last quarter of the year is the worst economically. In my former employment, approximately 1\3 to 1\2 of the employees in my plant could expect to be laid-off from their jobs because of lack of customer orders in the last quarter of the year. They would not return to their jobs until business increased 3 to 5 months later. Customer orders at Oregon Steel's Portland facility in 1989,1990, & 1991 were very good in the last quarter of those years. In 1992 and 1993, Oregon Steel experienced what the rest of the nation's steel companies experienced, "slow business". But, instead of following the tradition of laying off employees, OSM management opted to operate with out layoffs. This decision meant that profit participation for those quarters would be "0", partially because those profits that could have been recognized were paid in salaries to those that would have been laid-off. The flexibility offered by a profit sharing plan helped make this decision possible. The first quarter of 1994 at OSM paid employees only 6.75 % profit participation, yet in the first half of 1994, Steel Producing and Plate Mill Operations at OSM broke production records. Even though Profit Participation remained low,efforts by employees remained high. Increased compensation and job security for employees are potential benefits for alternative pay plans.

What are the potential benefits of alternative pay plans for the economy as a whole?

When companies share their profits with employees and in return receive extra effort from

their employees, it enables them to raise their productivity and quality and better compete in the market place. This ability to compete provides job security for not only their employees but for their vendors and suppliers. Utility companies benefit. Local governments benefit. Local merchants benefit. The economy as a whole benefits.
I worked for a company for 18 years and that company became unable to compete in the market place and closed its doors in 1986. The local economy was devastated and unemployment was 19% in our community.

From my experience, I feel that if employees in that company had a feeling of belonging, of being a part of the company, and been able to be part of a cost reduction effort as well as participating in profit sharing, that plant would still be operating today.

I would recommend that other companies and their employees adopt profit sharing plans.

In 6 short years, our country will be 224 years old and we will be ushering in the 21st century. In order for small business to compete in the 21st century, not only in America but also in the world market, employees will have to be involved in the work place. If employees are involved, profit participation needs to be a part of that involvement.

In closing, may I note that if employees are involved in company profit sharing, those employees also need to be empowered in the work place to accept responsibility and accountability for their actions and share in decision making on their jobs.

Thank you Honorable Committee Chairman, and Honorable Committee Members for hearing my testimony.

Burnie W. Reglan
Employee Involvement Facilitator
Oregon Steel Mills, Portland Division

July 15, 1995

Written testimony for a hearing of the Small Business Subcommittee on Regulation, Business Opportunities, and Technology - Rep. Ron Wyden, Chairman.

My name is Jacques D. Wimpfheimer, I am President and Chairman of A. Wimpfheimer & Bro., Inc. who own and operate American Velvet Company in Stonington, Connecticut. We began as importers of pile fabrics around 1845 in New Hampshire but have been manufacturing lightweight velvets in the same building in Stonington since 1892 - over 100 years. We make lightweight material primarily for the dress and needle trades, as well as for jewelry box, photographic and casket manufacturers, and retail. American Velvet employs approximately 250 people. It is a family business, I am the fourth generation and my son who is also in the business, represents the fifth. For the past 30 years we have had a weaving plant in Orange, Virginia that employs approximately 30 people and also own and operate a plant in Yorkshire, England that employs approximately 175 people.

We began in 1940 with a profit sharing plan that distributed our profits after taxes in cash. This was quickly changed to a before tax cash distribution and five years later to a combined plan that was 1/3 deferred 2/3 cash. The deferred portion had obvious tax benefits in that it was not taxed until distribution at retirement.

We changed to an all cash plan in the 70's because our deferred fund had not performed well for several years. The employees felt

that as it was their money, they were vested and had the right to handle it as they wished. We let them vote it out and since then we have had an all cash plan. In retrospect probably a bad move on our part.

In general, profit sharing plans should be tailored to the needs of the organization. Over the years we have made minor technical changes, however, fundamentally it is the same one we began with - roughly 20% of our profit is put into a fund. We divide our payroll into it and find a percentage figure. Each member of the plan is paid that percentage of his yearly earnings from the fund.

Looking back, I think that the best plan would be one that is 100% deferred with participants permitted to decide each year to take a portion in cash, if so desired. The tax benefits of a deferred plan are too good to pass up for an all cash distribution but there are times in one's life when cash is preferable. Younger employees would probably take more cash to meet immediate obligations: starting a family, school, houses, cars, etc. while older employees would probably want to save as much as possible for retirement. There should also be a choice of different types of fund to invest in: stock, savings, interest bearing, growth, etc. Ideally, I would like to see some tax benefits for the cash distribution profit sharing but it is hard to figure out what that could be, perhaps for school/college tuition, downpayments on homes, healthcare which is already covered, or something of that nature. Tax benefits for deferred plans are pretty good as they exist.

Profit sharing has come about because there are many of us who have known for a long time that there are important built-in weaknesses in the normal Labor/Management relationship. They are twofold and inter-related: (1) Employees have little or no opportunity to directly and immediately participate in their company's prosperity and (2) employers have not found adequate means to express recognition and appreciation for the interested efforts of employees, in direct proportion to company success. It is to meet these needs that profit sharing is employed. It does enable employees to participate in, and management to reward for the success of the company as, or if, it prospers, above and beyond existing wages and fringe benefits. Profit sharing is not a substitute for good competitive wages, it is in addition to them.

ADVANTAGES:

1.) It is an important cog in the co-partnership participative concept of Total Quality Management (TQM).

2.) It is a major incentive reward for work well done.

3.) It dampens hi-low fluctuation in business and wage cycles - makes longer contract commitments more acceptable for both parties.

4.) It fits hand-in-glove with TQM Programs.

For a proper system and plan to be effective, employer and employee must be completely aware of whatever is going on in a business - good, bad, production, quality, market, fashion, competition, future, costs.

5.) Cash plans put more money immediately in circulation.

Profit sharing can also be used to dampen inflation. In June of 1970, when the Nixon administration was considering wage-price controls to stop spiralling, I wrote them a letter suggesting: "Profit sharing incorporated into wage-price controls offers flexibility on the wage side that is most desirable and by itself tends to dampen the demand for fixed wage increases and most importantly, at the same time, creates and rewards increased productivity and builds understanding and cooperation between labor and management, a gap we all agree needs closing."

DISADVANTAGES:

Profit sharing is not all good.

1.) It cuts into cash flow.

2.) Deducts from bottomline and dividend distribution to passive investors.

3.) Where it exists it is an obligation that any purchaser of a company or part must accept.

4. In our case it is in our contract with the union and must be negotiated.

5.) Makes it close to impossible to accumulate capital for repurchase of sole owner stock to pay taxes.

6.) Total employee compensation fluctuates each year based on profits. This can make cash profit sharing difficult for some employees to manage.

A confusing contradiction or anomaly does exist when one realizes that one has to work harder when times are bad for poor or no rewards and when times are good work somehow is easier for better rewards. One learns with time to balance good and bad.

We are totally convinced that profit sharing has been a great help to us in surviving the last 50 years. Fifty years ago we had 10 or 12 competitors in the United States, today we have two. We are still manufacturing in New England at quite a severe handicap as compared to our competitors who are in the South.

I would always advise everyone to look into profit sharing and use it if they are willing to work at it. It is not a situation where you can turn on a faucet and forget about it. It is absolutely

imperative that if it is to be the great aid it can be, it must be worked at all the time by both management and employees. Our union does a great job along side of management - together we make it work.

An Address by

JACQUES D. WIMPFHEIMER

at the

THIRTY-FIFTH

Summer Conference

ST. HUGH'S COLLEGE, OXFORD

FRIDAY, 9TH JULY, TO MONDAY, 12TH JULY, 1965

TEAM-SPIRIT IN INDUSTRY

The vital factor in Britain's recovery

1965

Industrial Co-partnership Association

FOUNDED 1884

Thirty-Fifth Summer Conference

ST. HUGH'S COLLEGE, OXFORD

FRIDAY, 9th JULY to SUNDAY, 11th JULY, 1965

Team-Spirit In Industry

THE VITAL FACTOR IN BRITAIN'S RECOVERY

Chairman:

The Rt. Hon. Sir GEOFFREY SHAKESPEARE, BT.
Deputy Chairman, Abbey National Building Society
Director, Associated Portland Cement Manufacturers Ltd.;
Director, London Brick Co. Ltd.

Speakers:

The Lord HILL OF LUTON
Chairman, Independent Television Authority;
Director, Abbey National Building Society

D. BASNETT
National Industrial Officer,
National Union of General and Municipal Workers

Sir H. STANFORD COOPER, F.C.A.
Chairman, Co-partnership Farms Ltd.

J. A. C. HUGILL, D.S.C.
Managing Director, West Indies Sugar Co. Ltd., Caroni Ltd.;
Director, Tate and Lyle Ltd.

O. P. MARLAND
Director, Aspro Nicholas Ltd.

H. I. MATTHEY
Managing Director, Morgan Crucible Co. Ltd.

J. B. UPTON, M.B.E., T.D., D.L., J.P.
Chairman, Reckitt and Colman Holdings Ltd.

J. D. WIMPFHEIMER
President, American Velvet Co. Ltd.;
Chairman, Denholme Silk Weavers (British) Ltd.

The Meaning of Profit Sharing

I have about twenty-five minutes to speak to you about a subject I normally shrink from discussing. My reason for not liking to talk on the subject of profit sharing is that, generally speaking, for those who are already involved with it, it has become a personal matter—a way of life that is and must be worked out individually for the individual situation; to those not involved, it is extremely seldom that words can either interest them in it, or convince them of its value or importance. On the few occasions when I have found myself seriously extolling its virtues, I have felt like the man who stands on a street corner offering free dollar bills to passers by, and finds that people not only will not take them, but think and act as if he is a little mad. On this subject of profit-sharing I am not a bit mad.—I know and can prove that it works.

My family has been in the velvet manufacturing business in America since 1845 (I am the fourth generation) and here in England since 1962. We installed our first profit sharing plan in 1940, which makes me, for all intents and purposes, a second generation profit sharer. I remember when it did not exist, but I was not a member of management at that time. While I have almost always worked under and with profit sharing, I am, of course, well aware of the many other methods of running one's business life. I see them all around me every day. Ours is an integrated company to the extent that we begin with yarn and end up selling a dyed and finished piece of cloth to Jobbers (Merchants) and Manufacturers (Makers-up) in a variety of needle trades, as well as to jewelry box, display and coffin manufacturers and of course to retail stores.

The background to labor relations at our company, The American Velvet Company, from 1892 when we began manufacturing in Stonington, Connecticut, to 1940, the year that the first profit sharing plan was installed, was one of suspicion, industrial strife, and unrest that now and then led to stoppages and strikes. The unhealthy relationship that existed between absentee management and employee was very similar to that

which existed throughout American industry during the early part of the century.

In 1937, a collective bargaining contract was signed by the company and the Textile Workers Union, and in August of 1938 a sixteen months strike began over a management request that the weaving work load be increased from two to four looms per weaver. By this time my grandfather had died and the business was in the hands of my father and my uncle. They knew that to continue in business they had to win their point. It was a bitter and gruelling experience for all concerned. Management's choices were: (1) sell out and quit, (2) move South to a depressed area where unions were weak and labor costs low and utilities cheap or (3) stay in Stonington and work out a solution. My uncle, having had enough wanted out; however, my father wanted to continue and he wanted to continue right where we were in New England. To accomplish this he took over complete control of the company by buying out the rest of the family. Shortly thereafter, he negotiated a one year contract with the union that at least permitted him to go back into business and them to go back to work. The sixteen months had been a hard and sobering time and much thought had been expended by all concerned; both sides had suffered but each needed the other. My father was anxious to try some new ideas which I do not believe he could have articulated at the time. They were much more instinct than anything else.

Changes took place; top management became local and interested—actively present in the shop long hours of the day and night; it asked questions and took suggestions from the workers and their union; it shared information; it knew that it had to gain the confidence of the workers if it were to succeed, and to do this it had to convince the workers of its "Sincerity of Purpose," (a term used by my father day and night, and which, as a matter of fact, was a very fine capsule description of him).

Conditions and attitudes did not change overnight—looking back at it now the change seems to have been swift, and in the course of history, it was very fast—but there were many agonizing decisions to be made, and crises to be faced. Some members of management, who could not adjust to the new answers

to old problems, had to be replaced; the new face of the company had to be single and consistent; again, Sincerity of Purpose was the product for sale, and the still extremely wary employees had to be convinced before they would buy.

In 1939, a profit sharing plan had been offered by management for incorporation into the contract, but it was turned down by the union as "some kind of sharp management Trick." It was not until 1940, and the second contract between the company and the union, that profit sharing was incorporated into the agreement; and even then in the eyes of the employees, it was a concession on the part of the union. But it was also the first sign on their part that management's product, Sincerity of Purpose, was worth a second glance.

The spark that put it across was, in fact, a major concession on the part of management: the union wanted another one year contract and the company, for stabilization purposes, needed a three-year contract. To break the deadlock, it was pointed out that had they accepted profit sharing as offered in the 1939 contract, each employee would have received 11 cents on every wage dollar earned that year. That opened some eyes and caused some chagrined foot shuffling. Then they were told that if they would sign a three year contract, a profit sharing plan would be included in the contract and they would be paid the 11 cents per dollar earned for the previous year, even though the plan had not been in the contract.

In December 1940, the American Velvet Company and Local 110 of the Textile Workers Union signed a three year contract containing a profit sharing plan. This was the beginning, by contract, of an idea, a philosophy, a way of industrial and economic life, which from that day to the present, has meant continuous profits and a good deal of mutual respect and cooperation between the company and its employees.

Twenty-five years have passed since that day and while there have been a variety of modifications made to our plan, it has remained basically the same. The adjustments made have taken place as the relationship between labor and management has matured. It has taken mutual acceptance of each other, depth of

responsibility and the pride of one's fellow man.

Of course, a major factor in the development of the mechanics of our plan, or any plan over a period of years, are the laws of the land; our particular tax laws permit or dictate that we do things one way. Your laws lead you another way. For us in the United States there is an important advantage for the individual in the development of a Profit Sharing Pension or Retirement Fund—therefore, in 1947, we went from a straight cash distribution to a combined part-cash, part-deferred plan.

Today, as simply as I can state it, our plan is as follows: Each year, 27% of our profits, before taxes, are put into the Profit Sharing Fund and are distributed to each eligible employee. He receives 2/3 of his share in cash and 1/3 is placed to his credit in our Pension Trust. This is paid, of course, on top of going industry wage rates. Profit Sharing is not a substitute for wages.

I hope I have given you a description of the background and birth of our plan. It was the result, pure and simple, of the sincere belief of a man who felt that if people believed in one another and could work together, a job would get done and quite naturally all involved should share in the resulting fruits.

It took a great deal of work but rapidly (even though it did not seem so at the time) both management and labor had their proof—accomplishment! Since 1940, there has not been a losing year. Profit sharing has ranged from a low of five per cent of wages to a high of thirty-nine per cent. In all, $8,800,000 have been distributed under the plan. Wages have gone from an hourly average of $0.60 to $2.23 per hour and for the past two years we have been working three shifts six days a week, all year round. And, best of all, we have not had a single strike nor have we gone to arbitration to solve a single one of our problems.

Of paramount importance to our way of life at the plant is a system of communications that has developed haphazardly, over the years, which I think with some justification may be described simply as "man to man." Each morning the members of top management (i.e. myself down through department

heads) upon arrival at the plant, roam around it—naturally each emphasizes his own departments but certainly does not limit himself to them. We talk with anyone on any subject; last night's bowling or golf game; a new piece of machinery; a personal problem; a breakdown in production — anything! Three quarters of an hour later there is a top management meeting at which all problems and the morning's mail are gone over—each person reading each piece of mail—all discussing all problems; in general, we are convinced that problems are interrelated, department to department. The meeting ends only after a conference call to our sales office at which sales, production problems and programs are co-ordinated—only after all this do we go to our individual tasks.

On labor's part, they have a formal local organization which elects yearly a Shop Committee composed of nine of their in-plant members to represent them in discussions and bargainings with management, and to generally run their business.

"Shop Committee Meetings," i.e. meetings between management and the elected union committee may be called by either group to discuss almost any problem. We do have some formal grievance procedures which are set up to permit the handling of problems at a lower level. Of course, we try to handle all problems at as low a level as possible, but, because of the mutual feeling of responsibility, there are many things that each side wants to discuss and feels free to discuss with the other; both labor and management take the attitude that the company is a living organism off which we all live, and the stronger it is the better off we all are.

Besides the formal shop committee meeting where decisions are made at any time by mutual agreement, we have formed several other committees.

One called the "Pops" Committee, the fathers, or revered elders, so to speak, is a group composed of all the former presidents of the local union. Management calls them to meet at irregular intervals to discuss any and all sorts of problems—even to the point of getting their opinion on questions on which the members of management disagree. It is a group with power to advise but not to decide—it is a sounding board for new

ideas—nothing is too serious or too ridiculous to be brought up for careful consideration by the group. Its advice is very seriously considered, even though not always implemented in its entirety. This group was brought together for the first time and named by my father for the simplest of reasons. He believed that since the employees elected their own working in-plant union president, and as there was no pay for all the aggravation and often hard work of the job, the holder thereof must be a man who was held in respect by his peers, a man of ability and a man who was, above all else, selfless. This, in my father's eyes, made them top candidates for such a committee. He felt they had, Sincerity of Purpose—and he was right. They have, and still do serve well, even though several of them have moved on from union office to membership on management's team.

There is a sub-committee of the "Pops" Committee consisting of three members from management and three members from the "Pops"; they are called the Planning Board. It is a sort of court that gathers information on wages, work loads, job classification, overtime, maladjustment caused by new machinery or methods; in order to function to the fullest degree it may call in for information and discussion any member of the work force or management it thinks can help in the clarification of a situation. Its opinion, when reached, is presented to the Shop Committee as "findings," generally with a recommendation for action. However, positive action may only be taken by the duly elected employees committee and management meeting together at a Shop Committee meeting—that is the only place binding decisions may be made.

There are other committees, we are loaded with them—a Seconds Committee that deals with product imperfections, a Foremen's Committee that deals with management's problems at its lower levels—the Maintenance Department has a job evaluation and rating system, and they have a committee—any reason is taken to get people from both management and labor together.

Now what does all this mean? It means that we have some formal rules and agreements, but it means that we do not let

them get too much in our way. They are good strong guides for normal day to day action but when a crisis of some sort arises, it can be faced and solved then and there. Raises, adjustments in work loads, changes in fringe benefits have all been made during a contract period because either the company could afford it, or, quite the reverse, because the company needed help over a rough economic period.

While we have never tried to lead the industry in work load innovation, we do stay abreast of our competition. Since 1939, when labor finally, after sixteen months of fighting it, accepted the increase from two to four looms as a work load, there have been two other increases—from four to six, and from six to eight—each of these made in a developing climate of co-operation and mutual trust, without a moment's loss of time or production. The last of these work load increases, by the way, from six to eight looms, was made in the middle of a three-year contract, in spite of the fact that legally they probably could have blocked the move until the contract ran out. Certainly if the pre-1939 climate had still prevailed, there is no question that they would have used every means possible to do so, however, things had changed drastically. In this case it was mutually understood and agreed that it was economically necessary for the increase to be made in order to keep abreast of competition. Naturally, there was now full consultation and mutual planning, mechanical aids and improvements were developed to make it possible, and a corresponding adjustment in pay was granted—it was worked out in consort—and it worked. I take pride in saying ours are the highest paid, most efficient and most productive velvet weavers in America.

When we moved a major department, we let the workers from that department set it up themselves—they knew better than the rest of us how to simplify their own jobs. And another time ten or fifteen years ago, we had an unusually large inventory. The local union came to us on their own; they were worried. They offered us a loan from their National Treasury if we needed it and also suggested that we cut back production to four days a week for a while.

Now, as I have said, this sort of co-operation did not grow

overnight—it took time—but not too much once the sincerity of management was accepted by the members of labor. When that happened, a whole new source of energy and intelligence came into play and the company became a thing of power far beyond its size and importance as measured by most normal standards. We represent success through mutual respect, mutual co-operation, mutual participation and common dignity. Our Federal Government has frequently used us as an example for foreign industrial, educational or labor teams to visit and talk with. The National Planning Association in a study they conducted, has used us as an example of industrial peace under collective bargaining. International unions have used us as an example of how easy it is for management to get along with a union. We have been studied and dissected by a student from India in his doctoral thesis. In fact, I can barely understand what he says we are. He describes our simple human relationship in the damndest, most complicated technical terms and graphs that I have ever come across. I ordered 500 copies of his work intending to distribute them to our people, but after I read it I was afraid to do so. On paper we had become some sort of mechanical robots—the product of a button pushed on a computer—controllable, predictable, a mathematical equation—the last thing I want to feel I am, the last thing our people think of themselves, and, I truly hope, the last thing we are.

But now then, what are we? Or rather, what is the phenomenon of profit sharing—why does it succeed?

To begin with, I am one hundred per cent convinced that the monetary gain or compensation received under the system, while nice and very important is nevertheless certainly not the main fuel that energizes the power elements that drive a company that has a successful profit sharing plan in operation to its heights. No, the distribution (cash or otherwise) is a symbol of the success—the reminder—the frosting on the cake—all very pretty—all very important, but not nearly so important as what the system itself does for the human beings involved.

Man is an animal, born on this earth with a conscience, and the best way to get him to function effectively is to give him responsibility; in this day and age a thing not so easy to do. Cer-

tainly in industry, the large majority of employees work at jobs that are monotonous, boring and truly uninspiring, can you imagine waking up each morning knowing you have to spend at least eight hours—probably one half of your waking hours—at a job that offers you no challenge, from which there is very little chance of advancement, or which permits you not the slightest expression of your individuality—what would you do? Probably what most people do—close off your mind to what you are doing—dream of roses, fishing, winning a football pool, problems with the wife and kids at home—or the girl next door!

Well, profit sharing offers something else—one has the chance to make suggestions, save on waste, improve quality, increase quantity, and best of all, there are people about always willing to listen to your ideas, to try them out if they show half a chance of success, to use them if they work, to explain why if they do not and always to thank you and to ask for more! Too, you and your fellow workers get something back for it at the end of the year, you and everyone else working together in a joint effort to do something extra; give something extra and get something extra—men being men—doing men's work.

Profit sharing permits a man to be a man—he exercises his desire for responsibility, his conscience is at work, he has dignity—he is a full man and as a full man he has energy to expend and a willingness to expend it. A great, large source of now willing energy is tapped.

This is what profit sharing is—this is what it makes of man—this is why it works.

July 15, 1994

Written testimony for a hearing of the Small Business Subcommittee on Regulation, Business Opportunities, and Technology - Rep. Ron Wyden, Chairman.

My name is Tom Rezendes, I have worked for American Velvet for 26 years. I am a purchaser for the Company and am currently president of Local 110-T, Amalgamated Clothing and Textile Workers Union, AFL-CIO,CLC. My main responsibility as union president is to keep open the communication between employees and management, and to work toward solving problems between employees and management.

I feel that profit sharing at American Velvet has given employees reason to see that quality is maintained to the highest standard. You must remember that in talking about profit sharing at American Velvet, it includes almost every area: overtime, material spending, machinery maintenance, and quality. Weavers must pay close attention to their looms and catch a defect from the beginning. For example, if a weaver lets six yards of cloth go through with a defect, it costs the Company $6.00 per yard or $36.00 for the six yard piece. If a final inspector has a 1/4 yard of bad cloth and cuts off 3/4 of a yard, you have a 1/2 yard of cloth wasted. At the end of the year, this adds up to lost money which means lost profits. Technicians must keep up with the maintenance of their set of looms to keep downtime to a minimum and thus keep production up.

Profit sharing definitely has had positive effects on labor-management relations because all employees have as a goal our

profit sharing that we receive at the end of the year. Profit sharing works very well at American Velvet because the owners, the Wimpfheimer family, have a very open relationship with employees. The union can go to Mr. Wimpfheimer at any give time with questions regarding the financial aspects of the Company, including the profit at that point in time. Each morning there is a meeting made up of management, union and a department representative. Two books are brought to this meeting each morning, one consisting of sales figures in dollars, pieces and yards, and the other book consisting of factored sales, short and long-term loans and production figures. People are amazed that the Company is so open about their finances and their sales orders. I try to explain to them that this is how the business is operated and that we all share in the same goal, which is to work to the best of our ability to contain expenses, reduce the waste of materials, produce a quality product and in the end, a share of the profit.

Personally, I have found that if you neglect to remind your employees of the importance of profit sharing, they tend to stray from good quality and regardless of whether or not profit sharing is distributed every six months or once a year, you must keep up the awareness of what goes into making profit sharing work.

The work environment at American Velvet is family-oriented. The Company is small enough so that you get to know employees from all three shifts, both personally and professionally. This family atmosphere is important when problems need to be resolved.

American Velvet has had very few employee grievances and when problems do arise, management and union meet to resolve them.

When we haven't received profit sharing for a particular year, it has been very hard on employees. When this happens, you will find a negative response to profit sharing. Fellow employees will start to accuse one another of not doing their best throughout the year. It is very difficult to make it to the end of the year and have no profit, especially when you have tried to control expenses and also keep quality up. Once the year is over and employees have vented their frustrations, they bounce back and look to a new profitable year. The Company contributes to this change in attitude by stressing that control of material spending, machinery maintenance and quality is a key factor in profit sharing.

Examples of profit sharing figures:

1980 - no profit sharing

1981 - no profit sharing

1985 - 3.72%

1987 - 9.96%

1990 - 6.86%

I would recommend adoption of a profit sharing plan to other firms and their employees but one must be very careful in proceeding in this direction; like anything else you can't make employees accept it. Management and union representative should meet to make sure everyone understands the meaning of profit sharing and what the expectations are. When union representatives feel comfortable with their understanding of the proposed profit sharing plan, it can then be recommended to the employees.

Profit sharing is not something I would recommend for a large company. I feel it is easier to deal with questions and misunderstandings in a smaller company and such a company can be more successful in properly instructing employees on the subject of profit sharing.

STATEMENT PRESENTED TO

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON REGULATION,
BUSINESS OPPORTUNITIES, AND TECHNOLOGY

BY

DAVID L. WRAY

President

PROFIT SHARING COUNCIL OF AMERICA

10 South Riverside Plaza, Suite 1460

Chicago, Illinois 60606-3802

July 15, 1994

The Profit Sharing Council of America (PSCA) respectfully submits for your consideration the following comments on cash profit-sharing arrangements. PSCA is a national, non-profit association, established in 1947, of approximately 1,200 companies that sponsor profit-sharing plans for their nearly two million employees. Member companies range in size from small, entrepreneurial businesses to Fortune 50 companies. PSCA offers its members practical assistance with plan design, administration, investment, compliance and communication.

Employers establish profit-sharing plans for a wide variety of reasons, including to attract, retain and motivate employees and to increase company profitability.

• *Labor stability.* Surveys conducted jointly by PSCA and Hewitt Associates between 1973 and 1988 found that the average participant turnover rate at profit-sharing companies is 13 percent, a figure that is substantially lower than the national rate of 21.6 percent reported by the Bureau of Labor Statistics in 1987 (the last year for which this data is available). Further, a 1987 study by Douglas Kruse of Rutgers University found that profit-sharing companies have smaller employment decreases during employment downturns. This finding is substantiated in studies by James Chelius of Rutgers University and Robert S. Smith of the New York School of Industrial and Labor Relations at Cornell University, which found that "non-supervisory workers with profit sharing were about half as likely to have been laid off during the previous year."

• *Organizational commitment.* In a 1988 study, Gary Florkowski of the University of Pittsburgh Graduate School of Business found a very significant statistical relationship between organizational commitment, job satisfaction and profit sharing. His findings support a 1987 random-sample survey of 4,060 employees of British profit-sharing companies conducted by D. Wallace Bell and Charles G. Hansen. Seventy-three percent of survey respondents indicted that profit sharing had improved their attitudes and 68 percent felt that the introduction of profit

sharing had improved their view of the company as an employer.

• *Productivity.* For his 1993 book, Profit Sharing: Does It Make A Difference?, Kruse analyzed survey data on the corporate performance of 500 U.S. companies (half with profit sharing and half without) over the period from 1970 to 1991. He found that companies that had adopted profit sharing experienced sustained productivity increases of 3.5 percent to 5 percent. Edward Morse Shepard III of Boston College also reported a significant positive link between productivity and deferred profit sharing in a 1987 study of U.S. chemical firms.

• *Profitability.* A 1991 Profit Sharing Research Foundation (PSRF) study of 796 of the largest U.S. companies found that the 386 that shared profits were more profitable than the 410 that did not. This study supports similar conclusions from a 1969 study by Bion Howard and Peter Dietz of Northwestern University and a 1979 study by Howard.

In 1989 and 1990 surveys conducted by PSRF, a non-profit research organization affiliated with PSCA, companies were asked to indicate the degree to which their plans had accomplished various objectives. Objectives that stressed the ability of profit-sharing plans to attract, retain and motivate employees commanded the most responses in both years, with "increase employee retention" and "increase employee interest in the firm" placing first and second among participant responses (see Table 1 on page 3). Although companies identified fewer goals for their plans in 1990, the percentage that said that the plans had achieved "great success" in meeting the goal rose in 1990 for all but two options.

In addition, overall success ratings, calculated by adding the percentage of companies that reported "great" or "moderate" success for each option, remained relatively consistent (see Table 2 on page 3).

Table 1. Company objectives for profit-sharing plans

	Companies that identified this objective		Plan effectiveness rating for meeting objectives							
			Great success		Moderate success		No effect		Negative effect	
Objective	1989	1990	1989	1990	1989	1990	1989	1990	1989	1990
Increase employee retention	97.7%	95.4%	28 9%	30 3%	57 8%	49 5%	12.3%	19 1%	0 9%	0 5%
Increase employee interest in the firm	96 3	94 9	27 8	32.6	62 2	56.7	10 0	10 7	0 0	0 0
Sense of employee-employer partnership	91 9	90 4	18 2	36 0	67 0	52 9	14 3	9 0	0 5	2 2
Group incentive to motivate productivity	92 7	83 8	11 3	16 4	67.0	60 6	20.7	21 2	1 0	1 8
Recruit key personnel	88 6	80 2	20.1	23 4	64 9	53 2	14 4	22 2	0 5	1 3
Increae or stabilize profits	85 7	71 1	8.6	13 6	61 3	52 9	26 6	32 1	0 5	1 4
Enhance employee job security	79 9	61.4	14 3	21 5	48 0	41 3	36 0	36 4	1.7	0 8
Provide supra-wage benefits without fixed commitment	70 7	57 4	30 3	22.1	44 7	41 6	24 3	36 3	0.7	0 0
To lower costs	NA	40 1	NA	11 4	NA	43.0	NA	43 0	NA	2 5
Group incentive to increase safety	61 3	34 0	4 5	7 5	27 1	22 4	68 4	67 2	0 0	3.0
Provide a variable wage component	55 1	33 5	17 6	10 6	51 3	40 9	30 3	42 4	0 8	6 1
To lower prices	39.3	23 9	1.2	4.3	18.8	25 5	74.1	63 8	5.9	6 4

Source PSRF's Current Trends and Practices surveys, 1990 and 1989 "NA" means that the option was not available on the 1989 survey Respondents evaluated as many plan objectives from the list as they deemed applicable so percentages add up to more than 100

Table 2. Combined success ratings

Percentage of companies that said their profit-sharing plan was a great or moderate success in meeting each objective:

Objective	**1989**	**1990**
Increase employee retention	86.7%	79 8%
Increase employee interest in the firm	90.0	89.3
Sense of employee-employer partnership	85.2	88.9
Group incentive to motivate productivity	78.3	77.0
Recruit key personnel	85 0	76 6
Increase or stabilize profits	69.9	66.5
Enhance employee job security	62.3	62.8
Provide supra-wage benefits without fixed commitment	75.0	63.7
To lower costs	NA	54.4
Group incentive to increase safety	31.6	29 9
Provide a variable wage component	68.9	51.5
To lower prices	20.0	27.0

Source PSRF's Current Trends and Practices surveys, 1990 and 1989 "NA" means that the option was not available on the 1989 survey Respondents evaluated as many plan objectives from the list as they deemed applicable so percentages add up to more than 100.

Why companies sponsor cash profit-sharing plans

Cash profit-sharing plans are relatively easy to set up and to administer. They also are easy for employees to understand, which simplifies the employer's communication responsibilities. Plan contributions are deductible to employers and are taxable to employees as income, just like ordinary wages. Wage and hour regulations do apply, but the absence of a tax-deferral component means that cash plans are not subject to Internal Revenue Service approval.

Cash profit sharing differs from other performance-based pay arrangements, such as gain sharing, in that cash profit sharing is a team-based reward; it focuses on group results rather than on individual results. In addition, the amount of the cash profit-sharing distribution is based on the company's bottom line — its profits. Gain sharing and other performance-based pay arrangements tie the reward more closely to individual efforts and to specific productivity measures. For this reason, many service companies find that cash profit sharing is easier to implement than other performance-based pay arrangements because service companies cannot measure employee productivity as precisely as manufacturing companies can.

Although the typical cash profit-sharing contribution is made annually based on company-wide performance, other options are available to plan sponsors. Companies can base their contributions on the profitability of specific operating units, plants or stores, for example, and can make quarterly or semi-annual contributions, instead of annual contributions. Tying cash contributions to specific time periods and site performance reinforces employees' identification with the effort/reward dynamic.

Companies also may choose from a wide range of methods for determining the contribution. The following options are among the most common:

• *Discretionary contribution.* The company may contribute each fiscal year an amount determined by its board of directors.

• *Contribution determined by formula.* The company makes a contribution each fiscal year of an amount equal to a specific percentage of the pretax, pre-plan contribution profit. The company does not pay profit sharing for any year in which there is not a pretax profit. Pretax, pre-plan profit for the purposes of calculating the company contribution is determined by using the same methods as the company uses in the ordinary course of business. However, companies often exclude the following items for the purposes of calculating their contributions:

- Pretax income or losses related to charges or credits (whether or not identified as special credits or charges) for unusual or infrequently occurring items such as plant closings, business dispositions or sale of property, plants and equipment not used in the ordinary course of business, or intangible assets.

- Extraordinary items, such as repurchased debt, as reported on separate line items in the company's income statement.

After a company determines the total profit-sharing amount for the fiscal year, it then makes allocations for each eligible employee. Employees usually are eligible to participate in a cash plan if they are employed by the company on the last day of the relevant fiscal year and if they have completed a specified length of service. The length of service requirement typically falls between 90 days and one year. Some companies have no length of service requirement; others limit eligibility to permanent, full-time employees.

Individual allocations are calculated by multiplying the company profit-sharing contribution by the ratio of each eligible employee's compensation to the total compensation of

all eligible employees. It is possible to weight the ratio for service or performance by converting compensation to points and then establishing a point-allocation method for service or performance.

Cash profit-sharing payments normally are made within 90 days after the end of the relevant fiscal year. While the contribution can be paid in a single lump sum, some companies make two payments: one based on anticipated profits and the second on the company's final fiscal-year results. One popular distribution technique is to provide the initial payment in December before the start of the holiday season.

How prevalent is cash profit sharing?

Given cash profit sharing's obvious motivational benefits, administrative simplicity and design flexibility, one would expect it to be a fairly common practice. However, statistics indicate otherwise. For example, Employee Benefits in Medium and Large Firms, 1985, a Bureau of Labor Statistics (BLS) study, showed that only 1 percent of the employees in the companies studied were enrolled in cash-only plans, compared with 18 percent who were enrolled in all types of profit-sharing plans. In other words, cash-only plans covered about 5.5 percent of the employees who were covered by any type of profit-sharing plan.

PSCA and PSRF records show that approximately 5 percent of the plans at PSCA-member companies are cash-only plans. (Note: PSCA's membership includes many small companies, which the BLS study did not cover). Data from PSCA-member surveys, as well as past PSRF research, suggest that cash-only plans may be proportionately more prevalent in smaller companies. Most small-company cash profit-sharing plans go unreported for the simple reason that these companies have not adopted formal plans. Rather, these companies have

Table 3. Cash profit-sharing plans: analysis by number of employees

	Total number of U.S. employees					
	Under 500	500-999	1,000-4,999	5,000-9,999	10,000	All Cos.
Prevalence of cash profit-sharing plans	20%	15%	4%	13%	19%	16%
Age of plans:						
• 1 year or less	13%	25%	19%	17%	25%	19%
• 2 - 3 years	21	8	17	33	17	18
• Over 3 years	66	67	64	50	58	63
	100%	100%	100%	100%	100%	100%
Employee groups eligible for plan:						
• All exempt employees	70%	60%	70%	50%	73%	68%
• Selected exempt employees (e g., below executive level)	25	33	25	25	13	25
• Nonexempt salaried employees	52	87	68	75	80	69
• Nonunion hourly employees	41	53	55	25	40	47
• Union employees	7	7	16	13	13	12
	(Includes multiple responses)					
How company contribution is determined:						
• Specific profit-related formula	74%	73%	66%	75%	36%	65%
• Management discretion	26	33	23	25	28	26
• Other (e.g., determined by Board)	0	0	18	0	36	2
	(Includes multiple responses)					

Source 1989 Compensation Trends and Practices, published by Hewitt Associates, September 1989

developed completely discretionary cash profit-sharing arrangements that they use to distribute profits to employees during profitable years, while not committing themselves to making contributions in unprofitable years.

Hewitt Associates' 1989 Compensation Trends and Practices survey (the last year in which this data was collected) provides an analysis of the compensation practices for executive, field sales, exempt and nonexempt positions in 705 service and manufacturing companies. Cash profit sharing is defined by the survey as a broad-based plan that pays awards directly to employees in cash, although the plan may allow employees to defer their awards. The amount of the shared company contribution is based on company-wide profits or related financial measures (see Table 3 above).

About one out of six, or 16 percent, of the companies surveyed by Hewitt Associates

reported using a cash profit-sharing plan. The data is consistent with the results of previous Hewitt annual salary-increase surveys. The cash plans in surveyed companies usually were extended to most employees. While these plans typically were not new, 19 percent had been implemented in the last year. The actual company contributions usually were determined by a specific profit-related formula.

Hewitt Associates attributes the increasing popularity of cash plans to the appeal of contingent pay increases. Ten years ago, according to Hewitt, companies could increase salaries and easily pass the costs along to their customers, but today, foreign competition won't allow that. Cash plans are a way to link individual performance to organizational performance and reward employees only when the employer has the ability to pay.

How to encourage more companies to sponsor cash profit-sharing plans

For profit-sharing to succeed in the work place, companies must be willing to foster a corporate culture that encourages employee participation in managing their work. Without the ability to participate, employees have less opportunity to contribute to company profits, which undermines the motivational impact of profit sharing.

Cash profit-sharing plans perhaps depend even more than deferred plans on participative work cultures because employees see the immediate results of their efforts in an annual (or semi-annual or quarterly) cash distribution. Therefore, companies that do not plan to implement a participative work environment, or that only pay lip service to the concept without carrying it through, have little incentive for sponsoring a cash profit-sharing plan.

For those companies that are considering profit sharing, through either a cash or a

deferred arrangement (or a combination of the two), information about what plan-design options work best in specific situations should be collected and disseminated. One of profit sharing's greatest strengths is the flexibility it gives companies to design a program that fits its own unique circumstances. Past PSCA surveys of hundreds of companies' profit-sharing contribution formulas, for example, indicate that no two companies compute their contribution in exactly the same manner.

However, some similarities do exist, and PSCA's annual surveys of profit-sharing and 401(k) plans and other surveys conducted by the Department of Labor, the Employee Benefit Research Institute and service providers generate hard data on plan design, administration and investments. But each survey has its limitations. To provide a clearer picture of how profit sharing actually works, we need to develop a more effective way to collect information about actual practices and to quantify the results.

PSCA fully supports all government efforts to expand the use of profit sharing, including additional tax incentives. As recently as 1987, Senator Dale Bumpers of Arkansas introduced a bill to "encourage managers and employees to show that they have confidence in one another and in the future by adopting cash profit sharing." The bill proposed a 25-percent tax exclusion for employee cash profit-sharing distributions. No action was taken on the bill.

However, several industrialized nations currently provide tax incentives for cash profit sharing. For example, the United Kingdom enacted legislation during the 1980s to provide tax incentives to employers and employees for cash profit-sharing plans. According to Delwyn H. Kegley of the Wharton School at the University of Pennsylvania, British employers and employees have a choice of three types of profit-sharing or profit-related pay plans: cash plans that provide for periodic cash payments to employees at either a specified amount or at management's discretion with no tax incentives; approved deferred share trusts, which are plans

with tax incentives; and profit-related pay (PRP) plans with cash payments and tax incentives. The British government's original proposal for PRP in 1986 would have granted tax relief to employees who agreed to take 20 percent of their income from a profit-sharing plan, but critics argued that 20 percent would shift too much risk to employees during economic downturns. The final version of the law "suggested" that PRP could be introduced in place of a conventional pay increase or coupled with conversion of some existing pay to PRP. As finally adopted, PRP is a cash profit-sharing plan that provides participants with tax relief up to 10 percent of pay.

France also provides tax incentives for cash profit sharing. Since 1959, payments to voluntary cash profit-sharing programs based on company trading profits or productivity improvements have been exempt from corporate income tax, social-security contributions and other payroll taxes, but allocations received by employees were taxable. In 1967 France introduced compulsory profit sharing for all companies with more than 100 employees (later changed to 50 employees). The compulsory profit-sharing system provides that when a company's net profits exceed 5 percent of its capital, a portion of those profits, calculated by a standard formula, is paid into a special profit-sharing reserve. The payment is tax deductible for the company and is exempt from both employers' and employees' social-security contributions provided it is frozen for five years by company agreement. In 1986, legislative changes made voluntary cash profit-sharing plans more attractive: a maximum of 12 percent of payroll was fixed as the distribution ceiling and payments were exempted from employers' social security tax and corporate income tax.

For tax incentives to be truly effective in the United States, however, and to encourage new plan formation among small companies in particular, such incentives must not be tied to complex and costly new regulatory structures. PSCA's 36th Annual Survey of Profit Sharing and 401(k) Plans found that small companies with deferred profit-sharing plans already are paying an average of $167 per participant for recordkeeping costs. Decisionmakers at small

companies also should benefit personally from their companies' qualified plans. Owner/ managers run nearly all small companies and personally incur the costs required to fund and administer profit-sharing plans, because those costs come directly from their profits. Tax-related incentives for profit-sharing plans must be substantial enough to help offset some of these costs.

Conclusion

Cash profit sharing is not a new concept — The Procter & Gamble Company pioneered the use of cash plans as early as 1887. Cash profit sharing continues to exist in the United States because of the many benefits it provides to both employers and employees. PSCA applauds government efforts to foster an environment that encourages more companies to sponsor cash profit-sharing plans and offers its assistance and resources to further this goal.

Remarks on Organizational Performance and Rewards
by
Jerry McAdams, CCP
Divisional Vice-President, Performance Improvement Resources, Maritz Inc.
Director, Consortium for Alternative Reward Strategies Research
for the
United States House of Representatives
Committee on Small Business
Subcommittee on Regulation, Business Opportunities, and Technology
July 15, 1994

Thank you for your kind invitation to share the results of our four year research project on the relationship between reward plans and organizational performance. I am Jerry McAdams, Director of a non-profit organization, the Consortium for Alternative Reward Strategies Research, called CARS for short. My day job is Divisional Vice President of St. Louis-based Maritz Inc. We are a privately held, $1.4 billion dollar company in the travel, marketing research, and turnkey performance-improvement businesses. I've been involved in this field for 20 years, served on the White House Conference on Productivity in 1984, and have co-authored the three largest studies published on this topic.

The CARS research is not limited to cash profit sharing. We have in analyzed a variety of performance-reward plans and their benefits to both the organization and the employee. I cannot address their effect on the economy as a whole. That's not my area of expertise, except to the degree that the economy is affected by improved business performance and more rewards for employees.

I don't want to tell you more that you want to know about this rather complex subject, so I'll just hit the highlights. I've provided the Subcommittee with copies of the Executive Summary of *Organizational Performance & Rewards – 663 Experiences in Making the Link*. The full report, all 400 pages of it, provides the experience of organizations in the private sector who have attempted to link their performance with rewards for their employees. It is published by the American Compensation Association.

These plans are clearly an opportunity for performance improvement through people. Like all such opportunities, however, plans require effort, money, support and good-will from all involved. Depending on the plan design, they can also provide a healthy return on the organization's investment. A subtle, but critical point – these plans are certainly different from traditional, "cost-of-doing-business" compensation programs.

Background

In 1990 I founded the non-profit CARS organization with Elizabeth J. Hawk of Sibson and Company and with the financial support of the American Compensation Association, GTE, Maritz Inc., Monsanto, Motorola, and The Travelers. Since that time AlliedSignal, Federal Express, Ohio State University, and Texas Instruments have become Consortium Members. Our mission is to improve organizational performance by providing information that enables organizations to better define, design, implement and evaluate performance-reward plans for nonmanagement employees.

In order to accomplish this goal, the Consortium conducted an in-depth study beginning with 80,000 contacts, identifying 10,000 plans and determining 2,200 that fell within the scope of the research.
The scope of the research reflects what the CARS expert Advisory Board believes are the necessary elements to assure a plan can affect organizational performance. Any legislation being considered for special treatment of these plans must, in my opinion, include these elements. Briefly, these elements are:

- A focus on strategic objectives ... profit, quality, productivity, customer satisfaction, safety, cost reduction, cycle time, etc.
- Rewarding the rank and file employee (non-sales), although management can participate, in a non-competitive fashion.
- A pre-announced formula for earning that linked organizational unit performance and an individual's reward (organizational unit can be a company, division, department, facility, work group 20 or larger). Management may not use its discretion on the actual distribution of the awards to individual after the performance has improved.
- Payouts within a year (no deferral of reward into a retirement account)
- Awards not limited to cash. Stock, merchandise, travel, etc. are also important and commonly used awards.

663 plans were studied in depth, covering 1.4 million employees. Merit, skill-based, competency, or sales-based pay systems, as well as suggestion plans, are not included in our research.
The study found that plans were best defined based on what they *measure and reward.* Plans fall into one of the following three categories:

Financial Plans use "bottom line" measures -- specifically profit, earnings and/or return calculations -- as the only basis for payouts. "Current profit-sharing" plans would fall into this category.

Operational plans use some combination of productivity, quality (internal or external), attendance, safety, cost reduction, output, or project milestones measure to determine payouts. (Three to five measures are used.) "Gainsharing" and "goal-sharing" plans would typically fall into this category.

Combination Plans combine both financial and operational measures to determine payouts.

I'll describe a typical plan. An organization has decided that profit, productivity and quality are measures of their most important strategic objectives. Each measure is given a baseline based on historical performance. The dollar value of the performance improvement.. a *gain*... is determined. (As an example, 1% improvement in productivity is worth $100,000 per year.) Each measure is assigned an award schedule. (Each 1% improvement in productivity earns each employee $300 in cash or noncash awards.) Each period, usually every month or quarter, performance is measured and rewards are made. With this approach, a net return on payout can be calculated.
These are a few of the key findings from *Organizational Performance & Rewards*:

- Performance-reward plans are designed to make the link between rank and file employees (and their management) and organizational performance improvement. They are not treated, administered or evaluated as traditional compensation plans.
  Comments: Strategic business plans are instituted to improve an organization's performance. The role of performance-reward plans is to make the connection between where employees focus their energy and creativity and the organization's objectives. They are "worked" (communicated, reassessed, involving) just like any other strategic business plan. All of this is in contrast to traditional compensation plans installed to "attract and retain" individual employees, rather than improve organizational performance.
- Performance-reward plans **lead** organizational change as much as they **support** (or "lag") it.
  Comments: We are finding organizations use performance-reward plans to get everyone involved. It accelerates the change process.
- Plans work in most environments -- union and nonunion -- manufacturing and service.
  Comments: This not a union or nonunion issue. Everybody wins in a successful plan. We did not study government or non-for-profit organizations, except in health care. There is no reason to assume however that performance-reward plans would not work just as effectively in these settings. The opportunity for performance just might overcome the red tape.
- Payouts are modest -- a median of $867 per employee per year -- about 2.9% of base pay.
  Comments: We used to think it required from 10 to 30% of base pay to get an employee to improve their performance. Actually, those amounts were necessary to get people to work harder, not smarter or become involved in the improvement process. When an employee is treated as a valued asset and involved in the process, the reward is just part of the reinforcement.
- Gains -- the dollar value placed on the performance improvement -- were a median of $2,410 per employee per year. These gains are driven by the **operational** (productivity, quality, etc.) measures, rather than the **financial** (profit, return on assets) ones. **Financial** plans could not put a value on the change in their payout measures.
  *Comments: The issue is "line of sight"... the perception of an individual's ability to affect a result. The longer the line of sight .. profits in a large organization or a small one unwilling to share information with employees .. the less effective the plan. The shorter .. productivity in a 300 to 500 person organizational unit .. the more effective the plan. Frankly, we believe that **except** in small organizations where management is willing to share profit information, profit sharing will not improve profits. Operational plans, however, demonstrate significantly improved operational performance. There is some evidence that combination plans can improve organizational performance, as well.*
- Relating gain to payout is a close approximation to net return on investment = 134%. The median plan earned $2.34 for every dollar spent on payouts.

Comments: This is as close as we can get to a return on investment. Overall, the median plan paid for itself and then some. We did not find correlative data between profitability and the reward plans themselves. This is due, in my opinion, to three things:

1) The inability of our accounting systems to track operational measures

2) The organizational units with plans would not release what they considered to be confidential profit data, assuming they had it.

3) Profit is "after the fact" and is influenced by a number of factors other than the performance of the collective employee population.

We did find out, however, that organizations with performance-reward plans tended to do the same or better than their direct competitors. In addition, we found over a four period, 1989 - 1992, plans reported consistent payouts and gains. The recession did not seem to affect their performance. Forty-two percent of the organizations had layoffs of a median of 5%.

- *Operational* and *combination* plans are the most successful in terms of gains, net return on payout, satisfaction, improving communications, teamwork, and morale.
  Comments: These plans clearly have a better line of sight than financial plans.
- Plans are more successful if they have management support at all levels -- especially first line supervisors.
  Comments: The greatest credibility lies with the manager closest to the employee.
- Twelve percent of the plans were terminated because they did not perform against their payout measures. The majority of the rest are regularly reassessing, changing their objective, measures, and focus.
  Comments: Most plans are announced for a specific period of time. If they don't work, they are changed or dropped. They are not entitlements. They are dynamic strategic efforts. This is particularly true with operational and combination plans.

Generally, the respondents of the CARS survey indicated that cash was the primary instrument for rewarding their employees. Recent Conference Board research, however, suggests plans with a quality focus tend to use more noncash awards that cash. This is certainly true with sales plans. Examples are merchandise or recognition (symbolic) awards. In APQC and ACA's *People, Performance and Pay* only 2% of the plans used noncash awards. The latest data show from 10 to 16%.

Although employees value cash greatly, they will most likely forget about these smaller cash payouts. Noncash rewards are generally earned through a token economy (points paid out in an award credit check) that will be accumulated over time for larger awards. These tangible awards tend to be seen and used every day, reminding the employee how they earned it, who sponsored it, and what business goal was met. They are as appropriate for organizational performance-reward plans as they are for recognition ones. They are particularly powerful in cost-reduction and safety plans. When one of the objectives of a plan is to increase employee awareness and understanding of the improvement process, noncash awards have an additional value to their obvious financial and motivational one.

Recommendations

My purpose today is to make you aware of the research that generally shows real benefits for both the organization and the employee in these plans.

I have not spent a great deal of time exploring what governmental action could be taken to enhance these plans. We spent 18 months working on that issue in 1984 for the White House Conference on Productivity. The primary results being increased awareness of the importance of performance-reward plans and the Malcolm Baldrige Quality Award.
The obvious recommendations are:

1. Unlike traditional compensation plans, which pay for **doing** a job but not necessarily how **well** it is done, performance-reward plans pay out only when an indicator of an organization's performance improves. That contributes to an improved economy and job stability. It would be appropriate to provide tax incentives to both the organization and the employee based on the cash or noncash awards earned. That would encourage more organizations to implement them.
2. Barring my first recommendation, the new tax law requires a 28% withholding for any bonuses paid to employees, except for lower paid employees for which actual estimated withholding can be used. This inflates the perceived cost of the plan to the organization. Moving this back to 20% or less would send a positive message to the business community.
3. Recent NLRB rulings tend to restrict the opportunity for groups of employees to work together on performance improvement efforts. These rulings are clearly counter-productive, do little to protect labor, and can retard a critical element in performance-reward plan's effectiveness.
4. Finally, the Government could be a role model for these plans by piloting them in appropriate departments. The traditional pay plans need to be improved as well, but the red tape and civil service regulations will probably extend that process well beyond my years. Performance-reward plans provide an opportunity to reduce costs, improve productivity and quality, focus on safety and customer satisfaction ... all things alluded to in the Vice President's effort to reinvent Government. This is one way to really make a difference.

Conclusion

Performance-Reward plans clearly provide an organization a way to link employee's actions to strategic objectives, regardless of the objective. They provide a dynamic tool that can (and should) be started, stopped, changed or redirected as required by the business and its objectives.

Organizations making a more effect link between employees and organizational results have generally believed it made good sense intuitively. Now we have evidence that it makes good business sense, as well.

Thank you.

Executive Summary

Organizational Performance & Rewards

663 Experiences In Making The Link

By
Jerry L. McAdams, CCP
Elizabeth J. Hawk, CCP

A Research Project of

American Compensation Association

Conducted by the
Consortium for Alternative Reward Strategies Research:

AlliedSignal Inc. • American Compensation Association
Federal Express Corp. • Maritz Inc. • Motorola
Ohio State University • Texas Instruments Inc.
The Travelers Insurance Companies

Past Consortium Members

GTE • Monsanto

Advisory Board Members

Center for Effective Organizations • Center for Workforce Effectiveness
Hay Management Consultants • Hewitt Associates • KPMG Peat Marwick
The Roth Group • Rutgers University • Sibson & Company Inc.
Society for Human Resource Management Foundation
Towers Perrin • Washington University
William M. Mercer Inc. • The Wyatt Co.

Research Sponsors

HayGroup

Hewitt Associates

The Global Leader

SIBSON & COMPANY

SHRM FOUNDATION

Towers Perrin

WILLIAM M. MERCER INCORPORATED

Wyatt

Table of Contents

	Page No.
Introduction	4
Background	5
Key Findings	8
Summary Findings	
Plan Objectives	9
Communication	10
Employee Involvement	11
Communication and Employee Involvement vs. Payouts	12
Business Performance	12
Other Pay Plans	13
Plan Development	14
Employees Covered	15
Design Feature – Performance Measures	16
Design Feature – Gains	18
Design Feature – Payouts	18
Design Feature – Link to Organizational Objectives, At-Risk, Reserves, Deferral, Competition	20
Management Involvement	21
Nonmanagement Employee Involvement in Plan Implementation	23
Results	23
Results – Gains and Payouts	24
Results – Relating Payouts to Gain	27
Results – Satisfaction	28
Results – Nonfinancial	29
Plan Administration	31
Plan Reassessment	31
Plan Termination	32
Longitudinal Data	34
Conclusion	35
Acknowledgments	37

INTRODUCTION

North American business leaders realize they must use every asset they have to compete in the marketplace – whether that marketplace is across the street, the country or the ocean.

It is becoming common for those leaders to describe employees as part of their asset base, vital to the organization's success. Large sums are spent to support these human assets – with base pay, merit or market-based increases, benefits, deferred incentive plans, training and more. Perhaps inadvertently, we have come to view these expenditures as simply costs of doing business, the price of admission.

There are two problems with this view of the programs that support an organization's human assets. First, when we include them in the category "cost of doing business," we ensure a focus on controlling and minimizing them. Costs, after all, are to be reduced or avoided. And second, even those programs that begin dynamically can quickly become stale and stagnant.

For example, the new bonus plan, based on profits and feeding a 401(k), is given a lot of attention at first. So employees sign up, but the plan soon slips into an administrative mode. Participants wait passively at the end of each operating period to learn how much has been deposited into their accounts. The plan has become an entitlement – another cost of doing business.

Business leaders take an entirely different approach when they make investments in intellectual and physical assets to improve competitiveness, often as long-term investments. Calculating the exact return on these investments may be difficult, impossible or simply not worth the effort. R&D, customer satisfaction systems, buildings, new products and up-to-date equipment are just a few of the more obvious examples. These investments are made because their value is clear, whether or not the value can be calculated in dollars.

Organizational Performance & Rewards – 663 Experiences in Making the Link is about performance-reward plans – plans that clearly link rewards to performance for employees below the management level. In this report we demonstrate that these plans are an investment in performance improvement. In many cases, attractive returns on the investment can be calculated. These plans are certainly different from traditional, cost-of-doing-business compensation programs.

Performance-reward plans are initiated to change or shape the employee's focus on strategic business objectives. They are designed to improve performance. They are "worked," just like any business strategy. Note the similarity between other business strategies and performance-reward plans – actions are taken and measured, progress is regularly monitored, reassessment reviews are held, modifications are made, and, if appropriate, the net return on investment is calculated.

The plans researched for this study provide a channel for the creative energy, attention, and contributions of employees – and there is something in it for both the organization and the employee. They represent a "win-win" (or "earn-earn") opportunity. Like all such opportunities, however, they require effort, money, support and goodwill from all involved. The good news is these plans can also provide a healthy return to the organization.

This study investigates reward plans designed to improve organizational performance, primarily through non-management employees. From 10,000 variable pay plans initially considered, we identified 2,200 "organizational performance-based reward plans" implemented by organizations and business units that chose to use a performance-reward plan to support their business objectives. Many plans from the initial 10,000 were screened out of the study because they applied only to management or because management retained discretionary control over the distribution of awards.

Of the 2,200 plans that survived the stringent screening process, *Capitalizing on Human Assets*, our first research report, examined 432 in depth. *Organizational Performance & Rewards – 663 Experiences in Making the Link* incorporates the original data base and augments it with updates and new plans.

The 663 plans in this study operate in some 372 companies with total employment of 10 million and total sales of $351 billion. The plans cover 1.3 million employees in manufacturing and service industries, some union and some nonunion. The plans are distributed as shown in the following table.

	Manufacturing	Service	TOTAL
Union	22%	6%	28%
Nonunion	38%	34%	72%
TOTAL	60%	40%	100%

This study reports what works, what doesn't work and why. In this *Executive Summary*, we have captured what we believe to be the key results and interpretive comments from the full research report.

A Note of Caution to the Reader

1. The findings and conclusions included in this report relate only to the 663 performance reward plans in the data base. These results **cannot be projected to the world (the universe of performance-reward plans) at large nor are they in any way "best practices."**
2. **Conclusions in this report may not be compared** to the conclusions in *Capitalizing on Human Assets*, our first research report. This report incorporates the plans on which *Capitalizing on Human Assets* is based, plus 231 more. Comparisons of the two reports, to determine what happens over time, would only be valid if the lists of plans in the two data bases are the same. Since this is not the case, a longitudinal section is provided to report on what happens to specific plans over multiple years.
3. We have worked hard to **avoid implying causality.** Our statistical analyses support statements of relationships; they do not support claims that one element **causes** another.

BACKGROUND

Recognizing the Value of the Work Force

In the early 1980s, a growing number of North American firms began the process of increasing the asset value of their work forces. Seeking ways to engage all employees in achieving organizational success, line management tested innovative human resource practices (e.g., self-directed work teams, employment security policies and intensive information sharing). Some used alternative reward strategies (e.g., gainsharing and skill-based pay). Anecdotal information suggested that a combination of empowering human resource practices and reward strategies that connect rewards to organizational objectives could make a significant difference to results. In addition, there was an increasing awareness that improvement is not about focusing on a few top performers, but rather about teamwork, cooperation and "mutual fortunes."

Moving Toward Performance-Reward Plans as Strategies to Improve Organizational Performance

Top and line management are beginning to incorporate human resources and compensation professionals into the process of designing and implementing strategic organizational performance improvement processes. A key element is the use of performance-reward plans. Far from entitlements, these plans are, in fact, calls to action.

Today, organizations use performance-reward plans as an element of competitive advantage in support of their business strategies. They have recognized that a performance-reward plan – properly designed, implemented and maintained – can be a valuable part of the way an organization manages for improved performance. Probably one of the most durable contributions to this field was made in 1984 by the Reward Systems Committee of the White House Conference on Productivity. It is particularly helpful to review the primary results of that work.

Elements of a Competitive and Productive Organization

The White House Conference on Productivity's Reward Systems Committee addressed reward systems and human resource practices as a means of enhancing employee motivation toward achieving corporate strategic objectives. It defined four essential "building blocks" for organizational performance improvement:

1. A high degree of information-sharing, including business, financial, competitive, performance and planning information. This includes consistent upward information flow, or feedback from employees to management.
2. A general sense of employment security; this does not mean lifetime employment guarantees, but regularly communicated statements of the relationship between business realities and employment stability.
3. A mechanism for employee involvement in meeting business objectives. If nonmanagement employees really can make a difference, a productive organization must provide an easy way for them to make contributions toward improving performance. The vehicle may be ad hoc (e.g., quality circles, labor-management teams, multi-functional task forces) or may be integral to the fabric of the organization (e.g., self-directed or autonomous work groups and ongoing quality of work life efforts).
4. A system that rewards for performance. Unfortunately, most individual-based "pay-for-performance" programs are not particularly effective in encouraging organizational performance improvement. In many cases, they put employees in competition with one another, or they become entitlements. Plans that focus nonmanagement employees on organizational objectives may offer more effective alternatives.

Each of these elements exists to some degree in all organizations. The degree to which they are practiced offers the organization a way to determine how much progress is being made toward engaging employees in performance improvement and where emphasis is still needed.

The CARS research tests objective and subjective performance-reward plan results against these four basic elements. In addition, it examines the relationship of plan design, operation and reassessment to plan results.

Scope of the Research

Organizational Performance & Rewards provides a framework for future evaluation of plans. ***This research is plan-based, not company-based.*** The distinction is critical, because in many cases a single company/organization will have a number of performance-reward plans, each designed to meet different objectives with a different employee population.

Organizational performance-reward plans included in this research:

- Measure *and* reward at any level of the organization – organization-wide, business unit, facility, department, work group or individual (when a common measure covers at least 20 employees)
- Are expressly designed for nonmanagement employees (but can include executives and managers) and do not limit the awards to a few "winners"
- Have a clear, pre-announced performance-payout link
- Do not require that all payouts be deferred.

Measuring Plan Success

This study documents eight ways to measure plan performance. Not all eight will be appropriate for every plan, but they do offer a benchmark, a place to start.

These plan performance measures – also the dependent variables of this study – fall into three categories:

1. Financial results:
   - Dollar value of performance improvement (gain) per employee per year
   - Payout per employee per year, reported either as a dollar value or as a percent of base pay
   - Payout-to-gain relationship
2. Management's satisfaction with plan results
3. Nonfinancial results, subjective ratings of how much the plan contributed to the original plan objectives:
   - Improved business performance
   - Improved teamwork, including communications and employee involvement
   - Improved performance-reward linkage
   - Improved quality of the work force

For consistent analysis and clear communications, plans are defined based on ***what they measure and reward.*** After four years of testing this method for categorizing plans, these definitions continue to be the easiest to understand and use.

Financial plans use "bottom line" measures – specifically profit, earnings and/or return calculations – as the only basis for payouts (173 plans; 26 percent of the total). "Current profit-sharing" plans would fall into this category if they meet other study criteria, including specifying the performance-reward link up front and paying currently, rather than deferring awards.

Operational plans use some combination of productivity, quality, attendance, safety, cost reduction, output or volume, or project milestone measures to determine payouts. No bottom line financial measure is used (348 plans; 53 percent of the total). "Gainsharing" and "goal-sharing" plans would typically fall into this category.

Combination plans combine financial and operational measures to determine payouts (142 plans; 21 percent of the total).

In addition, data is reported for all plans, manufacturing plans and service plans.

KEY FINDINGS

Plans are defined based on what they *measure* and *reward.*
There are three kinds of plans:

- ***Financial:*** Reward on P&L measures – profits, return calculations.
- ***Operational:*** Reward on operational indicators – productivity, quality, cost reduction, safety, customer satisfaction, etc.
- ***Combination:*** Reward on at least one financial and one operational measure.

- Performance-reward plans are designed to make the link between rank-and-file employees (and their management) and organizational performance improvement.
- Performance-reward plans lead organizational change as often as they support (or "lag") it.
- Plans work in a variety of environments – union and nonunion, manufacturing and service. These plans cover a total of 1.3 million employees.
- Although plans include rewards as a critical element, the rewards themselves are just one part of a total strategy to improve performance – along with communications, employee involvement, feedback and financial justification of the plans.
- Plans are installed to improve business performance through people, rather than to "attract and retain" employees.
- Payouts are modest – a median of $867 per employee per year – about 3 percent of base pay.
- Plans reporting more intensive communications, feedback and involvement also report lower payouts. An employee treated as a valued asset and involved in the process of performance improvement does not require as much direct financial reward as one who is not.
- The median gain – the dollar value placed on the performance improvement – is $2,410 per employee per year. Gains are driven by the operational (productivity, quality, etc.) measures, rather than the financial (profit, return on assets) measures. *Financial* plans could not put a value on the change in their payout measures.
- At median, organizations earned $2.34 for every dollar they spent on payouts; thus a close approximation of net return on plan investment is 134 percent.
- *Operational* and *combination* plans are the most successful in terms of gains, net return on payout, satisfaction, improving communications, teamwork, morale and the performance-reward link.
- Plans are more successful if they have management support at all levels – including first-line supervisors.
- Plans are more successful when they are regularly reassessed to stay current with business strategy. They are dynamic strategic efforts – particularly *operational* and *combination* plans. Twelve percent of the plans were terminated, most often because the organization failed to perform well on plan measures.
- Organizations with performance-reward plans tended to perform the same as or better than their competitors.
- Over a three year period, 1989 - 1991, plans reported reasonably stable payouts and gains. The recession did not seem to affect their performance.

PLAN OBJECTIVES

Performance-reward plans are for improving organizational performance. "Attract and retain" are not primary objectives.

We began by examining the reasons these plans were installed. Other than the specific measures on which payouts are made, what did the organization expect to accomplish with the plan? Did they seek to "attract and retain" better employees? To answer a growing sense of entitlement among employees? To improve morale? We wanted to know whether performance-reward plans were implemented as part of an overall business strategy or were considered just another form of compensation.

The answers were clear. The plans were installed to:

- Improve business performance
- Improve teamwork through
  - Enhancing communication of unit objectives
  - Fostering teamwork
  - Improving morale
- Improve the performance-reward link

These are not the typical "attract and retain" compensation plan objectives. In fact, the more traditional objectives of compensation administrators – notably making total compensation more competitive, improving retention and recruiting, and allocating rewards to high performers – were ranked quite low as expectations for these plans. The lower importance ratings for these objectives reinforce our belief that these performance-reward plans are not viewed as traditional compensation programs. Instead, respondents' expectations center around organizational performance improvement.

Plans can lead as well as support organizational change.

Survey results suggest that many organizations view reward plans as a way to lead change. This is contrary to a common assumption that performance-teward plans can only be supportive – that is, the organization has to shift its culture first, then talk about reward plans. Instead, half of these plans were used to drive change in their organizations. Plans used as lead strategies can encourage greater information sharing, employee involvement and recognition for organizational performance.

The primary purpose depends on plan type – financial plans for awareness; operational and combination plans for performance improvement.

Nearly half of the financial plans reported their primary purpose was to enhance employee awareness and identification – the "softer side" of plan objectives. The primary purpose of operational and combination plans, on the other hand, is more commonly to achieve incremental performance gains or to support continuous improvement – purposes more likely to call for a hard-nosed assessment of quantifiable plan results.

COMMUNICATION

Communication to employees and teamwork results are related.

Organizations that routinely share information regarding business performance report more improvement in teamwork as a result of their performance-reward plans. When these communications are *regularly scheduled*, rather than delivered *solely at management's discretion*, the following plan categories report significantly more improvement in teamwork.

	Teamwork
All Plans	↑
By Industry	
Manufacturing	↑
Service	↑
By Plan Type	
Operational	↑

(Throughout this report, when results are identified as "significant," we mean that we have demonstrated the result using rigorous statistical analysis.)

About 80 percent of all plan types formally communicate with employees on either a monthly or quarterly basis.

Formalized feedback opportunities are just as important to teamwork as top-down communication.

Organizations with established formal feedback opportunities for employees also report significantly more improvement in teamwork vs. those organizations without these opportunities. (See page 25 for comments on the relationship between communication and payouts.)

	Payout as a Percentage of Base Pay	Teamwork
All Plans	↓	↑
By Industry		
Manufacturing	↓	↑
By Plan Type		
Financial	↓	↑
Operational		↑

Eighty-nine percent of all plans are in organizations with one or more feedback processes in place. Across the board, more organizations rely on group meetings vs. focus groups or surveys to secure feedback from employees. This is encouraging, since focus groups tend to involve only a sample of employees, and surveys are a noninteractive way of getting employee feedback.

Communication as a part of the performance-reward plan itself is important to plan results.

T e research shows that 81 percent of all plans regularly communicate performance on payout measures at least quarterly. Service plans lag manufacturing in using a variety of communication methods. Regular use of memos, newsletters, meetings and/or video provide excellent opportunities to educate employees about the specifics of the plan and company performance in general. Service plans appear to miss out on this opportunity more frequently.

Plans with regular communication report significantly higher plan results in the following areas (see page 25 for comments on the relationship between communication and payouts):

	Payout as a Percentage of Base Pay	Satisfaction	Business Performance	Teamwork
All Plans	↓	↑	↑	↑
By Industry				
Manufacturing	↓	↑	↑	↑
Service		↑	↑	↑
By Plan Type				
Financial		↑	↑	↑
Operational				↑
Combination	↓ marginal	↑	↑	↑

EMPLOYEE INVOLVEMENT

Most organizations have employee involvement programs in place.

"Empowerment" is a popular word in today's business press. Employee involvement is the enabling mechanism that allows empowered employees to put their ideas and expertise into action. Involvement includes vehicles like quality improvement groups, suggestion plans and self-directed work teams.

ALL PLANS			
Type of Employee-Involvement Programs	Percent Using Program	Median Percent of Employees Participating	Median Number of Hours Spent per Participating Employee per Year
Individual Suggestion Plans	42%	20%	5 hours
Ad Hoc Problem-Solving Groups	44%	20%	22 hours
Team Group Suggestion Plans	28%	25%	10 hours
Self-Directed Work Teams	19%	40%	56 hours
Employee Management Teams	19%	15%	40 hours
Quality Circles	26%	16%	50 hours
Percent of All Plans Using Any Type of Employee Involvement Program	66%		

Typically, from 25 to 40 percent of employees are active in some form of involvement program, spending an estimated 30 to 50 hours per year (less than 35 minutes to one hour a week) in formal activities. This level of involvement seems modest.

Organizations with more employee involvement programs report better teamwork results and lower payouts.

Organizations that make greater use of employee involvement programs report better teamwork improvement from their performance-reward plans. (See below for comments on the relationship between employee involvement and payouts.)

	Payout as a Percentage of Base Pay	Teamwork
All Plans	↓	↑
By Industry		
Manufacturing		↑
Service		↑
By Plan Type		
Financial	↓	

COMMUNICATION AND EMPLOYEE INVOLVEMENT VS. PAYOUTS

If communications, feedback and involvement are higher, payouts tend to be lower.

We have seen that those organizations that communicate more and involve employees also report better results from their performance-reward plans. The same organizations tend to report *lower* plan payouts to employees – a finding that may seem curious at first. However, we suggest this result supports the case that these plans are much more than a way for employees to earn more money.

In the early history of incentive plans for nonmanagement employees, plans typically paid 15 to 30 percent of base pay. These "highly leveraged plans" encouraged employees to work harder, not smarter, and it takes a large award to motivate harder work. The newer performance-reward plans represented in this study integrate communication, employee involvement, feedback and reward into a total business strategy. When organizations communicate, involve and listen, the size of awards, while still important, becomes less critical. Award sizes of 3 to 10 percent of base pay become more typical, as opposed to 15 to 30 percent.

BUSINESS PERFORMANCE

We attempted to look at the business performance of organizations participating in the survey. Relating sales and profit results to the plan is not a practical matter, in part because so many of the plans are in a unit of a larger organization. These units couldn't (or wouldn't) report their separate financial results. However, we did ask each survey respondent how the organization has performed relative to its market and the types of organizational changes and development activities it has implemented during the past two fiscal years.

Organizations with plans report doing as well as or better than their competitors.

Even though 1989 through 1991 were recessionary years, 90 percent of the plans say their business performance is at least the same as or better than the market in which they compete.

TQM, team focus and customer satisfaction are the most common development activities, but have no relationship to results.

Major Organizational Development Activity	Percent of All Plans Reporting This Focus	Percent of Manufacturing Plans	Percent of Service Plans
Quality Focus, TQM	47%	50%	42%
Team Focus	46%	50%	38%
Customer Satisfaction Focus	42%	42%	42%
Major Organizational Flattening	25%	29%	20%
Major Change in Product or Service Competitiveness	10%	9%	11%

Considering the effort that organizations put into designing and implementing major organizational development activities, we looked for their relationship to plan results. We were surprised to find that for organizations that have rededicated themselves to quality and customer satisfaction (nearly 50 percent of the plans), there is no relationship between this emphasis and plan results. These organizations may be taking a longer-term view of their development, and may have not yet realized concrete results.

Economic conditions influence the performance of virtually all industries. The 1991 recession, followed by slow economic growth, is reflected in the data presented above. More than half of the participating organizations are operating in a depressed market, while only 10 percent face improved market conditions. Slow growth and depressed markets have prompted many businesses to restructure or undergo major organizational flattening. Respondents report that these actions have had a relatively neutral effect on the organizational unit. It is interesting that in the service industry and in operational and combination plans, those reporting better business performance (compared to others in their market) were correlated with improved performance gain. Others, faced with significant changes in competition and depressed markets, have pursued organizational development efforts (Total Quality Management, focus on teams and/or focus on customer satisfaction). Respondents believe that these efforts have had positive effects on the organizational units implementing them, but we found little relationship to actual results.

OTHER PAY PLANS

Median base pay is $30,000.

The annual base pay per employee eligible for a plan is shown in the following table.

Annual Base Pay	All Plans	Manufacturing	Service
75th Percentile	$40,000	$37,500	$41,795
50th Percentile	$30,000	$30,000	$30,000
25th Percentile	$22,180	$23,850	$20,720

Organizations that position base pay below market report higher payouts and gains.

We asked where organizations position their base pay – below, at, or above market. In many categories, "below market" organizations report better financial results.

	Performance Gain	Payout as a Percentage of Base Pay
All Plans	↑	
By Industry		
Manufacturing	↑	
Service		↑
By Plan Type		
Financial	↑	↑
Operational		↑

It is possible that some organizations may begin paying out at a lower performance threshold in order to more rapidly close the gap with the market in total compensation. However, we have no specific data to support this hypothesis.

PLAN DEVELOPMENT

The report examines where the idea for a plan originated and who supported it, how the design was developed, and who approved the final plan design.

Top management is most often the initial champion of the plan.

Sixty-three percent of the initial plan champions are from top management, as opposed to 21 percent from human resources. Hopefully, "championship" does not mean simply issuing a directive to "get us one of those plans," but rather a top management team that is involved and supportive throughout the process.

The role of top management as champion reinforces the finding that these plans are designed to improve business performance. Rarely does a change in base compensation or a new element of a benefit plan have top management as its initial champion. Performance-reward plans are a dynamic way of directly supporting business objectives.

Results are different for plans designed at headquarters and plans designed locally.

Plans mandated and designed at headquarters (typically financial plans) report significantly higher gains and payouts. Plans initiated and designed locally (typically operational plans) report better nonfinancial results.

Most plans are developed by a task force.

When nonmanagement employees are included as task force members, plans report better nonfinancial results. However, plans designed by management-only task forces report higher gains.

We can describe a typical design task force.

If plans designed by task forces perform better in many areas than those mandated by headquarters, it is important to examine these task forces closely. Following are typical characteristics of these groups:

- Members are selected by management. Only 15 percent report that design team members volunteered for the assignment, and about 8 percent use elected employee representatives.
- The task force is made up of six employees.
- Forty-eight percent of plans using task forces include only management employees as members; the remaining 52 percent include both management and nonmanagement members.
- A median of 45 employee-days are invested in actual design meetings, although the range around this median is wide.
- Median elapsed design time is 15 weeks; again, the range is wide.

EMPLOYEES COVERED

Twenty-seven percent of the plans cover the entire corporation and 73 percent cover an organizational unit within the corporation. The 663 plans in this study cover 1.3 million employees.

	All Plans	Manufacturing	Service
Total Number of Employees Covered by These 663 Plans	1.3 million	540,000	740,000

When a unit has a plan, nearly all employees in the unit are covered, regardless of the size of the unit.

The following table shows the number of employees covered by these plans.

Number of Employees Covered	All Plans	Manufacturing	Service
Largest	120,000	54,500	120,000
75th Percentile	986	722	1,600
50th Percentile	315	297	370
25th Percentile	109	113	100
Smallest	20	20	20

Compensation professionals have long believed that smaller plans have a greater effect on employee behavior because employees can see more clearly the impact of their efforts on results. This is often referred to as "line of sight," the ability of the employee to see the impact of his/her efforts.

Financial plans tend to cover a larger number of employees, and are thought to have a longer line of sight. Operational and combination plans, on the other hand, tend to cover fewer employees and are believed to have a shorter line of sight. Subsequent research using the CARS data by Todd R. Zenger and C.R. Marshall of the John M. Olin School of Business at Washington University finds that plans in smaller organizations or units are in fact more successful.

It is not a common practice to "carve out" certain employee types and limit plan coverage to them. It is much more common to include almost everyone – regardless of the size of the unit. As the "Plan Objectives" section of the full report points out, the second most important goal at the time of plan design is teamwork; it makes sense that these plans would commonly include everyone as participants.

You can *put a performance-reward plan into a unionized organization.*

Union Employee Participation	Manufacturing Plans	Service Plans
Percent of Survey Population That Is Unionized	19%	23%
National Data from the Bureau of Labor Statistics (Private Sector Only)	5.5%	6%

The plans included in the CARS data tend to come from organizational units of larger companies in which union representation is a higher percentage of the total employee population.

DESIGN FEATURE – PERFORMANCE MEASURES

We studied the criteria used to measure and *reward performance. Profit, productivity and quality are the most common measures.*

Category of Measure	Percent of Total Plans Using this Measure
Financial – Profit, Return Calculation	47%
Operational Measures:	
Productivity	44%
Quality	45%
Safety	21%
Output/Volume	31%
Cost Reduction	23%
Attendance	12%
Project Milestones	8%

Many plans have measures from more than one category, so the total is more than 100 percent.

The number of measures used to determine payouts varies depending on the industry and type of plan. The median number of measures is three.

	Median Number of Payout Measures	Range
All Plans	3	1-50
Manufacturing	3	1-25
Service	2	1-50
Financial	1	1-5
Operational	3	1-34
Combination	4	1-50

Plans with three to five measures report better results.

The optimum number of plan measures has always been a difficult question. Conventional thinking suggests that plans with more than three to five measures become too complex to be effective. Therefore, we compared plans using only one or two measures, plans using three to five measures and plans using six or more measures. The following table reports those cases in which one of these design choices significantly outperformed the others.

	Satisfaction	Business Performance	Teamwork	Performance-Reward Link	Quality of Work Force
All Plans	3 to 5 measures	3 to 5 measures	3 to 5 measures	3 to 5 measures	1 or 2 measures
By Industry					
Manufacturing		3 to 5 measures	3 to 5 measures	3 to 5 measures	1 or 2 measures
Service	3 to 5 measures	3 to 5 measures	3 to 5 measures		
By Plan Type					
Operational		3 to 5 measures	3 to 5 measures	3 to 5 measures	1 or 2 measures

The data suggest that more measures are better – up to a point. This may be because plans that use more measures take a more comprehensive look at business performance, and are more customized to the needs of the organization. We note, though, that plans with six or more measures did not report better results in any category.

Financial measures generally measure performance above the facility level; operational measures generally work at or below the facility level.

Most financial measures record performance at the company or division level. Operational measures are most often taken at the facility level.

There were no significant relationships between the level of the organization at which performance is measured and rewarded and plan results. This may be because the organizations in our study varied greatly in size, so there was no reliable relationship between level of organization and number of employees covered by the plan. In the "Employees Covered" section of this *Executive Summary*, the relationship between size of the group covered and results is explored, and significant results are reported.

DESIGN FEATURE – GAINS

About one-third of the plans use a predetermined split in their plan design.

Some plan designs establish up front how the value of improved performance (gains) will be split with employees. They define how much of the gain will be shared with employees through plan payouts, and how much will be retained by the company. About 33 percent of the plan designs included a split on at least one of their performance measures, most often on a quality measure. The most common splits ranged from 15 percent (employee)/85 percent (organization) to 50/50 percent.

It is often assumed that performance-reward plans should specify how gains will be shared with employees, but we do not necessarily agree. This assumption probably dates from some of the traditional plan design types (for example, Scanlon® plans), in which the split was always specified and was used as a major element of plan communication. We have noted that the plans in this study are generally viewed as strategies to improve business performance, and we think this approach is a far better communication "hook" than is a split formula. Of course, a split between employees and the organization can only be specified if gains are to be valued in dollar terms, and many plans do not calculate the value of their gains.

DESIGN FEATURE – PAYOUTS

Payouts are targeted at 5 percent of base pay at goal.

About 40 percent of the plans in the study established a target payout for a target performance level. More than three-quarters of these plans communicate the size of the target to participants.

	All Plans
Percent of Plans Targeting What They Intended to Pay Out	41%
Median Payout as a Percentage of Base Pay	5%
Median Annual Base Pay	$30,000
Targeted Payout per Employee per Year	$1,500

Typically, top managers who participate in plans have targets of 25 percent of base pay, while nonexempt employees have 5 percent targets.

Plans with larger payout potential report better results for all employee types.

	Performance Gain	Payout as a Percentage of Base Pay	Net Return	Performance-Reward Link	Quality of Work Force
Top Management	↑	↑	↑	↑	↑
Middle Management	↑	↑	↑	↑	↑
First-Line Supervisors	↑	↑	↑	↑	↑
Exempt Nonmanagement	↑	↑		↑	↑
Nonexempt Clerical/ Administrative				↑	↑
Nonexempt Production/ Craft/Service				↑	↑

It is no surprise that plans with higher targeted payouts also have higher actual payouts. As shown above, these plans also report better results on other financial and nonfinancial indicators.

Payouts are most often an equal percent of pay to all or equal dollars to all.

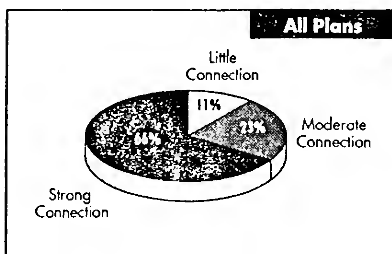
There is often a fair amount of debate between these payout options. About 30 percent of the plans chose equal percent, and a similar portion chose equal dollars. The decision depends, in part, on the message the organization wants to send via the plan. Equal percent of pay to all may reflect the perceived level of each employee's contribution. Equal dollars to all may better support an environment of teamwork and common fate.

Plans with financial measures tend to pay out annually. Operational plans pay out more frequently.

Plans designed to pay out only once a year may miss an important opportunity to reinforce direction and celebrate results. More frequent payouts mean less delay between performance and reward, greater ease in relating employee performance to outcomes, and shorter line-of-sight. We found that plans designed to pay out four or more times per year reported higher payouts and more improvement in performance-reward linkage and the quality of the work force. Plans designed to pay out annually or semi-annually reported a higher net return on their payouts.

DESIGN FEATURES - LINK TO ORGANIZATIONAL OBJECTIVES, AT-RISK, RESERVES, DEFERRAL, COMPETITION

The most successful plans clearly link plan measures to organization goals.



The relationship between a stronger link to organization goals and nonfinancial plan results is clear.

	Satisfaction	Business Performance	Teamwork	Performance-Reward Link
All Plans	↑	↑	↑	↑

This suggests a clear advantage to plans that design measures to meet the objectives of the unit they support. It also refutes the common assumption that plans that are "pulled off the shelf" can be successfully used in many organizations. Like other business strategies, performance-reward plans must be customized to the organizational unit they support.

Plans with at-risk elements show better results.

Plans with at-risk elements report better nonfinancial results in business performance and teamwork.

	Plans Including an "At-Risk" Element
All Plans	19%
Manufacturing	20%
Service	18%
Financial	19%
Operational	21%
Combination	13%

At-risk is generally implemented by reducing future base pay increases. Perhaps the most interesting finding, given some of the publicity surrounding at-risk plans, is that plans with an element of pay at-risk did not report more unfavorable results in any area. An at-risk plan sends a clear message to employees: Some portion of present or future "people" costs must vary with organizational performance. Employees will be partners with the company, sharing both rewards and risks.

Why don't more plans take this approach? Traditional compensation programs have nurtured a mentality of entitlement over many years. A prime example is regular base pay increases (whether they be COLAs, negotiated increases or "merit" budgets) that are based largely on what the competition is paying. Unless the company is in real trouble and freezes base pay, these increases do not relate to company performance. Such programs, used over many decades, teach employees to expect they will be paid independent of company performance. Against this backdrop, it is difficult to move to a system that poses any threat to these expectations, even if any downside risk is well balanced with upside opportunity.

Reserves, deferral of awards and competition are rarely part of plan designs.

Of the 15 percent of the plans that incorporate a reserve feature, the median reserved portion of interim payments is 25 percent.

Only 10 percent of the plans let employees choose whether to defer part or all of their awards to retirement or savings plans.

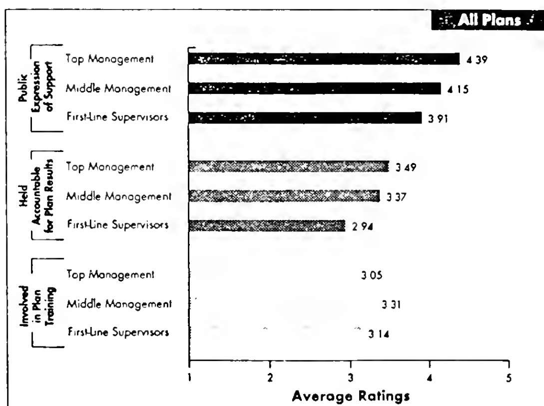
There is very little competition built into the plans we surveyed. In just 5 percent of the plans, employees or groups of employees compete against each other for the reward pool in a "zero sum" game.

MANAGEMENT INVOLVEMENT

It is axiomatic that management's support of any business strategy is critical to its success. Performance-reward plans are no exception. We defined support as "involvement" on three management levels (top and middle management and first-line supervisors) demonstrated in three ways – public expression of support, involvement in training and accountability for results.

Management involvement is important to plan results at all levels. Top and middle management are more involved than first-line supervisors.

Survey respondents were asked to rank the three levels of management in each involvement area on a scale of 1 to 5 (1 = no involvement to 5 = high involvement).



Public support, accountability and training involvement show a significant relationship to nonfinancial results.

PUBLIC SUPPORT	Satisfaction	Business Performance	Teamwork	Performance-Reward Link	Quality of Work Force
Top Management	↑	↑	↑		
Middle Management	↑	↑	↑	↑	↑
First-Line Supervisors	↑	↑	↑	↑	↑

ACCOUNTABILITY	Satisfaction	Business Performance	Teamwork	Performance-Reward Link	Quality of Work Force
Top Management		↑	↑		
Middle Management	↑	↑	↑	↑	↑
First-Line Supervisors	↑	↑	↑	↑	↑

TRAINING INVOLVEMENT	Satisfaction	Business Performance	Teamwork	Performance-Reward Link	Quality of Work Force
Top Management		↑	↑	↑	
Middle Management	↑	↑	↑	↑	↑
First-Line Supervisors	↑	↑	↑	↑	↑

First-line supervisors may be the "unsung heroes" of performance-reward plans. In nearly all cases, first-line supervisors are the least involved management level, yet the relationship of their involvement to plan results is strong. This makes sense because in many cases the first-line supervisor represents the organization to the majority of employees, and his/her clear support for the program is pivotal to its success.

Survey respondents report that all levels of management are more involved in publicly supporting the plan than in accountability for the plan's success and plan training. Perhaps others – like the human resources function – are taking too strong a role in assuming accountability for making the plan work. The lower levels of management accountability for plan results and training could be a particular concern when management turnover occurs. Incoming managers might not view plan success as a responsibility of their position. This suggests an opportunity to get more from performance-reward plans by increasing line ownership of results.

NONMANAGEMENT EMPLOYEE INVOLVEMENT IN PLAN IMPLEMENTATION

Involving nonmanagement employees in implementing the plan is an important consideration.

Forty-one percent of the plans report moderate to high involvement of nonmanagement employees in plan implementation. This could include involvement in developing and contributing to plan communication, conducting training meetings, and acting as the primary source of information about the plan for other employees.

Level of Involvement	All Plans	Manufacturing	Service
High	26%	33%	15%
Moderate	15%	18%	12%
Minimum to None	59%	49%	73%

Plans that involve nonmanagement employees in implementation have better results.

	Satisfaction	Business Performance	Teamwork	Performance-Reward Link
All Plans	↑	↑	↑	↑
By Industry				
Manufacturing	↑	↑	↑	↑
By Plan Type				
Financial		↑	↑	↑

RESULTS

Results can be both financial and nonfinancial.

Since performance-reward plans are viewed as strategies to improve business performance, it makes sense to apply a business standard when evaluating their performance. We did this by first asking respondents to report the dollar value of performance improvement (gains) they realized while their plans were operating. These gain values were compared to the amount paid out under the plans, and we calculated how these gains were split with employees covered by the plans. This was not necessarily easy for respondents; many plans had not been through the exercise of putting a dollar value on gains, and respondents often found their accounting systems were not especially helpful in accomplishing this task.

Of course, the dollar value of the gains does not tell the whole story. Many plans were not designed to deliver financially quantifiable returns. Some plan measures (customer satisfaction, attendance, some quality measures, etc.) simply do not lend themselves to attaching a dollar value to improvements. In these cases, payouts are investments for the organization.

Other plans may be aimed at returning improvements to the organization in the human resources arena, perhaps by encouraging greater employee participation or teamwork, or by increasing employee identification with business results. The plans are a cost to the organization because of the payouts to employees. But once again, the organizations that use them may consider them worthwhile investments, even an integral part of the way they do business.

RESULTS – GAINS AND PAYOUTS

Generally, financial plans cannot put a dollar value on gains.

Overall, slightly less than half the plans put a dollar value on gains. However, the majority of operational plans could value their gains.

	Percent Reporting Gains
All Plans	42%
Manufacturing	47%
Service	35%
Financial	17%
Operational	55%
Combination	39%

It may seem counter-intuitive that plans based on bottom-line measures – financial plans – typically could not value their gains. The reason may lie in the expectations of management and plan designers. We believe the discipline of putting a dollar value on the performance being rewarded is not frequently imposed on financial plans because:

- Financial measures are familiar to top executives and therefore may be less subject to pressure to demonstrate their value.
- These measures are well supported by accounting systems, which use bottom-line dollars to describe organizational performance (again reducing pressure to demonstrate value).
- A financial plan pays out from a pool of available funds, typically profits. Organizations may assume that as long as funds are available in the pool, payouts are justified.
- The concept of incremental performance improvement attributable to employee contributions (gains) simply doesn't fit for financial plans, particularly because many other factors can influence financial performance.
- Organizations using financial plans may feel that the plans promote employee identification with overall results, without expecting the plans to deliver quantifiable returns or to have a major effect on employee behavior.
- In some organizations, financial plans may simply become part of the pay package to which employees feel entitled, not unlike merit increases to base pay. It may simply not occur to these organizations to even try to attach returns to payouts.

Plans with operational measures (operational and combination plans) have just the opposite characteristics. From the beginning, they are often expected to demonstrate the value of the operational performance they are rewarding, because:

- These measures are not as familiar to top management, who may be skeptical of the value they deliver to the bottom line.
- The accounting system is not as supportive of operational measures, so the accounting function may demand that the plan demonstrate value.
- The plans generally do not pay out from a pool of available profit, but are expected to justify their payouts either by putting a value on performance gains, or by acknowledging the payouts as a pure investment in improving business performance.

As a result, plans with operational measures are much more likely to be able to put a value on their gains.

Gains are about $2,400 per employee per year.

	All Plans	Manufacturing	Service
Number of Plans (% of Total)	278 (42%)	186 (47%)	92 (35%)
75th Percentile	$5,109	$4,609	$5,563
50th Percentile (Median)	**$2,410**	**$2,625**	**$1,704**
25th Percentile	$975	$1,170	$607

	Financial*	Operational	Combination
Number of Plans (% of Total)	29 (17%)*	193 (55%)	56 (39%)
75th Percentile	$12,258*	$4,419	$5,082
50th Percentile (Median)	**$4,278***	**$2,271**	**$2,186**
25th Percentile	$1,177*	$1,008	$677

* *Because so few financial plans reported gains, readers should not base conclusions on this data.*

The ability to calculate gain has a direct relationship to nonfinancial results.

	Satisfaction	Business Performance	Teamwork	Performance-Reward Link
All Plans	↑	↑	↑	↑
Manufacturing	↑	↑	↑	↑

While the ability to calculate gains is generally associated with higher nonfinancial results, this relationship is driven by the manufacturing plans in the survey. There is no relationship for service organizations, which are less likely to be able to calculate gains.

Older plans seem to generate larger gains. This may be partially due to the fact that plans tend to add measures over time.

The size of payouts is strongly related to the size of gains.

Recall that the scope of this study was limited to plans that are designed to improve organizational performance. It is clear that, at least for the 278 plans in the data base that measure gains, the design works because payouts are strongly correlated to the dollar value of performance improvements.

Payouts are generally about 3 percent of base pay for all plan types.

Ninety-two percent of the 663 plans reported the size of their payouts, including 5 percent that reported payouts of zero dollars.

	All Plans	Manufacturing	Service
Number of Plans (% of Total)	610 (92%)	352 (88.4%)	258 (97.4%)
75th Percentile	$2,163	$2,072	$2,361
50th Percentile **Percent of base**	**$867** **2.9%**	**$819** **2.7%**	**$910** **3.0%**
25th Percentile	$391	$407	$370

	Financial	Operational	Combination
Number of Plans (% of Total)	165 (95.4%)	305 (87.6%)	140 (98.6%)
75th Percentile	$2,278	$1,767	$2,526
50th Percentile **Percent of base**	**$938** **2.9%**	**$718** **2.6%**	**$1,201** **3.6%**
25th Percentile	$390	$337	$439

Combination plans may pay out higher because they use financial measures, which give management a sense of security, *and* operational measures, which provide a shorter line of sight to employee impact on results.

RESULTS - RELATING PAYOUTS TO GAIN

Calculating the net return on payout is as close as we can come to a net return on investment ratio. Plans report a median 134-percent net return on payout.

For the 278 plans that were able to put a dollar value on their gains, the value of that performance improvement translates into a 134-percent net return on what they paid out to employees. The net return is calculated as follows: Assume one of these organizations calculated a performance gain of $2.34. The payout to employees totaled $1.00, for a net gain of $1.34. That is a 134-percent net return on payout, or a ratio of $2.34 gain:$1 payout. (The common 50/50 split between employees and the organization, by way of comparison, represents a 100-percent return on payout, or $2:$1.) The median net returns for the various types of plans are as follows.

	Net Return
All Plans	134%
Manufacturing	143%
Service	121%
Financial*	—
Operational	129%
Combination	100%

** Because few financial plans reported gains, the net return on payout would be misleading.*

We realize a 134-percent net return on plan payouts may be higher than expected. We looked into two important questions:

- Does a 134-percent net return take into account plan costs other than payouts?

  It does not. However, other costs (including training, communication and consulting charges, but not the cost of employee design time) for these plans are modest, typically around $40 per covered employee per year. This is not enough cost to materially affect the return on payout calculation.

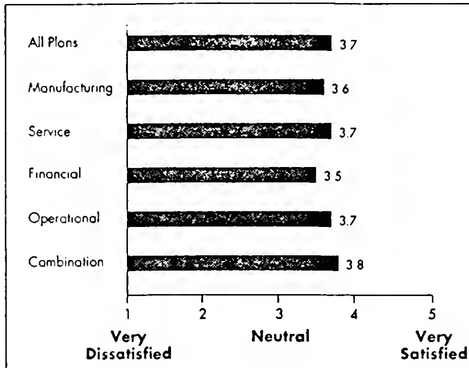
- Are the gains overstated?

  If anything, gains are probably understated. When respondents could not comfortably attach a dollar value to performance improvement, they reported zero gain.

RESULTS – SATISFACTION

Ratings of management's satisfaction with the plans fall between neutral and moderately satisfied.

Survey participants (typically plan designers or administrators) were asked to report management's satisfaction with the plan on a 1 to 5 scale, with 1 = very dissatisfied, 3 = neutral and 5 = very satisfied. The average satisfaction ratings are shown below.



Those plans that use operational measures (operational and combination plans) report higher management satisfaction than financial plans; the difference is statistically significant.

Management satisfaction is not related to the size of the gain or payout.

The size of the payout or gain is not related to the rating of management's satisfaction. However, the better the organization's performance relative to expected levels, the higher respondents rated management's satisfaction with the plan. Apparently, management's satisfaction with the plan is related to the organization's performance vs. expectations, but not to the absolute size of awards to employees or performance gains.

There is a strong relationship between management's satisfaction with the plan and non-financial plan results.

	Business Performance	Teamwork	Performance-Reward Link	Quality of Work Force
All Plans	↑	↑	↑	↑

RESULTS – NONFINANCIAL

Plan effectiveness also can be measured by nonfinancial results.

Thirteen separate nonfinancial results measures were statistically grouped into four nonfinancial result areas, as follows:

1. **Improving business performance,** a nonfinancial result that stands on its own
2. **Improving teamwork,** an area that includes these elements:
   - Enhance communication of unit objectives
   - Encourage intrapreneurship
   - Foster teamwork
   - Improve morale and/or employee relations
3. **Improving the performance-reward link,** an area that includes these elements:
   - Improve performance-reward link
   - Reduce entitlement mentality
   - Make labor costs more variable with organization performance
   - Become more competitive in total compensation
   - Allocate available award funds to high-performing individuals or teams
4. **Improving the work force,** an area that includes these elements:
   - Assist in recruiting
   - Improve employee retention
   - Upgrade the quality of the work force

These plans are most effective at improving business performance, communication, teamwork, morale and the performance-reward link. They are not installed to meet the "attract and retain" objectives of traditional compensation plans, nor are they particularly effective in contributing to these results.

Following are the ratings for the four nonfinancial results areas. The scale is 1 = the plan had no impact on the result; 3 = the plan was moderately effective in contributing to the result; 5 = the plan was highly effective in contributing to the result. The combined ratings for each of the four areas can be an incomplete picture, so we have included the separate elements within each area for which any of the ratings were 3 (moderately effective) or above.

Result	All Plans	Manufacturing	Service
Improve Business Performance	**3.28**	**3.32**	**3.24**
Teamwork (Overall Rating)	**3.05**	**3.14**	**2.91**
Enhance Communications	3.46	3.60	3.26
Foster Teamwork	3.18	3.29	3.02
Improve Morale	3.17	3.23	3.09
Performance-Reward Link (Overall Rating)	**2.57**	**2.48**	**2.70**
Better Performance-Reward Linkage	3.14	3.11	3.19
Quality of Work Force	**2.26**	**2.11**	**2.49**

Result	Financial	Operational	Combination
Improve Business Performance	**2.89**	**3.47**	**3.34**
Teamwork (Overall Rating)	**2.83**	**3.11**	**3.16**
Enhance Communications	3.19	3.51	3.69
Foster Teamwork	2.89	3.23	3.43
Improve Morale	3.03	3.26	3.16
Performance-Reward Link (Overall Rating)	**2.49**	**2.58**	**2.65**
Better Performance-Reward Linkage	2.89	3.26	3.15
Quality of Work Force	**2.38**	**2.16**	**2.36**

We compared these results to the ratings of importance of these objectives at the time these plans were designed, and found that the plans fell short of expectations. This could mean that expectations for the plans were unreasonably high. The shortfalls in plan performance also could be related to features found in many of the plans and organizations we studied. These include some plans' exclusive focus on financial measures, relatively low nonmanagement employee involvement in implementation and a low level of other employee involvement programs active in the organization.

PLAN ADMINISTRATION

Human resources generally administers the plan.

It is no surprise that most plans are administered by human resources.

Other parts of this study suggest that "working" a plan – actively using it as a tool to improve business performance – is far more important than "administering" it. This means that plans report better results when the focus is on communication, involvement, measures employees can influence and regular reassessment. Plans that do not include these active elements run the risk of becoming entitlements.

PLAN REASSESSMENT

Plans can undergo two levels of reassessment – simple adjustments to baselines and goals from one period to the next (usually an annual adjustment), or complete reassessment of the plan that could result in continuing the plan design as it is (perhaps with baseline adjustments), changing the design or terminating the plan.

When full plan reassessments are announced up front, plans report better performance.

Half the plans in this study tell employees in advance that the plan will be reassessed periodically and adjusted as necessary to keep it current with the organization's strategy. These plans report better results, perhaps because it is clear to participants that the plan is not an entitlement but an active strategy to improve performance.

	Business Performance	Teamwork
All Plans	↑	↑
By Industry		
Manufacturing	↑	↑
By Plan Type		
Service	↑	↑

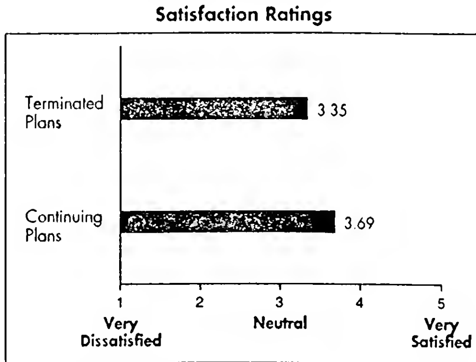
Financial plans are most likely to be "permanent"; that is, they are less likely to have regular plan reassessments. This is not unexpected, since these plans are more frequently mandated by headquarters and use bottom-line measures of performance. This lack of regular review by financial plans may be another factor contributing to their generally lower results.

PLAN TERMINATION

Eighty respondents have terminated or expect to terminate their plans at a future date. (In this section, we refer to all 80 as "terminated plans.") We do not know whether these organizations intend to replace the terminated plans.

There are significant differences between terminated and continuing plans in both management's satisfaction with the plan and nonfinancial results.

Satisfaction is lower in terminated plans than continuing plans.



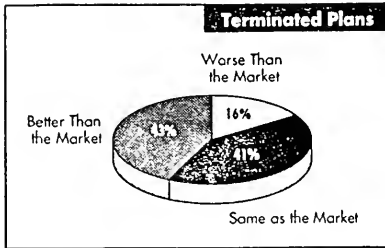
The difference in management's satisfaction with the plan between terminated and continuing plans is statistically significant.

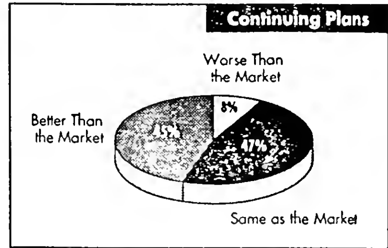
Nonfinancial results are lower in terminated plans than continuing plans.

We examined the shortfall between what the plans were expected to accomplish when they were designed and their actual nonfinancial results. In three categories – business performance, performance-reward link, and improving the quality of the work force – terminated plans had a significantly larger shortfall vs. expectations than continuing plans. In the fourth category, improving teamwork, terminated plans showed the same pattern vs. continuing plans, but the difference was not statistically significant.

We compared terminated and continuing plans in other areas. These differences, while interesting, are not statistically significant.

Business performance compared to the market in which the organization competes is slightly lower.





Fewer terminated plans can calculate a gain. Gains, payouts and net return on payout of terminated plans are lower.

Only 28 of the 80 plans (35 percent) were able to calculate a gain. This is lower than the percentage of continuing plans that could calculate gains (43 percent). Although the difference in gains between terminated and continuing plans appears large, it is not statistically significant. This may be because so few terminated plans reported gains.

	Terminated Plans	Continuing Plans
Median Gain per Employee per Year	$1,446	$2,426

The median payout per employee per year for terminated and continuing plans is about the same.

	Terminated Plans	Continuing Plans
Median Payout per Employee per Year	$955	$1,014

The median net return of terminated plans is 99 percent, compared to 146 percent for continuing plans.

Other characteristics of terminated and continuing plans vary, but not significantly.

	Terminated		Continuing
Median Number of Employees Covered	351	vs.	312
Percent Union Employees	30%	vs.	24%
Plan Age	3 years	vs.	4 years
Plan Design	More local design	vs.	More headquarters design
At-Risk Plans	19%	vs.	20%
Employee Involvement	More EI	vs.	Less EI

Terminated and continuing plans had similar profiles in the following areas:

- Payout Measures Used
- Payout Frequency
- Size of Targeted Payouts
- Connection Between Plan and Business Objectives
- Lead vs. Support Change
- How the Plan Is Primarily Viewed

LONGITUDINAL DATA

There are 174 plans that filled out both the first and second CARS survey. We are able to track these plans over time and identify changes in plan design and nonfinancial plan results.

Plans tended to add measures over time.

Payout Measure Added	Percent of Plans Adding this Measure
Output/Volume	21%
Cost Reduction	16%
Quality	14%
Productivity	13%
Financial	10%
Attendance	7%
Project Milestones	6%
Safety	5%

Nonfinancial results tended to improve slightly over time.

The 174 plans generally reported improved results on teamwork, performance-reward link and quality of the work force in the second survey. Ratings of plan effect on business performance declined slightly. However, none of these differences were statistically significant.

Payouts were generally flat from 1989 to 1990 and went up from 1990 to 1991. Gains followed the same trend.

There are 107 plans that provided payout data for the period covering 1989 through 1991. However, only 28 plans also reported three years of gain. For these 25 plans, the change in payouts and gains was minimal from 1989 to 1990 and 13 percent to 16 percent higher from 1990 to 1991. (Median percentage changes are calculated *separately*, the percentage changes shown below cannot be calculated from the dollar changes reported.)

Year	Median Payout per Employee per Year	Median Gain per Employee per Year
1989	$1,006	$3,236
1990	$1,078	$2,235
1991	$1,327	$2,566

Year	Median Percentage Change in Payout per Employee per Year	Median Percentage Change in Gain per Employee per Year
1989-1990	+2%	-0.11%
1990-1991	+13%	+16%

CONCLUSION

Performance-reward plans clearly provide an organizational tool to improve performance through people. They use rewards as a part of a total improvement process that also includes communication, involvement and measurement of results. They provide a dynamic tool, and can be started, stopped, changed or redirected as required by the business.

They offer the opportunity to lead or support change in an organization and they can pay for themselves – even provide a healthy return – as they do it. These plans have always made good sense intuitively. This research offers evidence that they make good business sense as well.

About the Project Directors

Jerry L. McAdams, CCP, is Vice President, Performance Improvement Resources, for Maritz Inc., where he has focused on performance-reward strategies for 20 years. McAdams served on the White House Conference on Productivity in 1983. He also serves on the Certification Program faculty for the American Compensation Association. In 1987, Carla O'Dell, Ph.D. and McAdams co-authored *People, Performance and Pay*, a report on a national survey conducted by the American Compensation Association and the American Productivity and Quality Center on nontraditional reward and human resource practices. In 1990, McAdams founded the nonprofit Consortium for Alternative Reward Strategies Research (CARS). He wrote the first CARS report with Elizabeth J. Hawk, CCP, *Capitalizing on Human Assets*, published by the American Compensation Association in 1992. He is published in human resource, compensation, management and general business journals. McAdams teaches performance-reward plan design in international workshops and is a regular speaker at management conferences.

Elizabeth J. Hawk, CCP, is Senior Consultant, Work and Reward Systems Redesign for Sibson & Company Inc. She specializes in helping clients develop reward programs that align with work systems to accelerate change and increase commitment. Prior to joining Sibson, she had 19 years of experience with Monsanto Co. in compensation and human resources, her primary focus was to assist the company's business units, manufacturing facilities and staff groups in developing performance-reward plans. Hawk is co-author of *Capitalizing on Human Assets*, published by the American Compensation Association in 1992. She is a member of ACA's Executive and Variable Compensation Committee. She speaks and publishes frequently on the subject of pay strategies.

About CARS

The Consortium for Alternative Reward Strategies Research (CARS) was formed in 1990. Its objective is to improve organizational performance by providing information that enables organizations to better define, design, implement and evaluate performance-reward plans for nonmanagement employees. It is a nonprofit effort, funded by consortium members, research sponsors and research-report sales.

The founding consortium members are the American Compensation Association, GTE, Maritz Inc., Monsanto Co., Motorola SPS, and The Travelers Insurance Companies. Current consortium members are AlliedSignal Inc., the American Compensation Association, Federal Express Corp., Maritz Inc., Motorola, Ohio State University, Texas Instruments Inc., and The Travelers Insurance Companies. Together, the consortium member organizations share a keen interest in improving performance through the effective use of reward strategies.

An Advisory Board provides expert counsel on all aspects of the project. The Advisory Board benefits from representatives of the following organizations who have been involved since the beginning of the project: Center for Effective Organizations, Center for Workforce Effectiveness, Hay Management Consultants*, The Roth Group, Rutgers University, Towers Perrin*, Washington University, William M. Mercer Inc.* and The Wyatt Co.* The original Advisory Board included representation from W.F. Corroon. The current Advisory Board also includes representatives from Hewitt Associates*, KPMG Peat Marwick*, Sibson & Company Inc.* and the Society for Human Resource Management Foundation*. (Organizations with an asterisk are research sponsors that have contributed financially to the project as well.)

About ACA

The American Compensation Association (ACA) is a not-for-profit association with more than 16,000 members who are engaged in the design, implementation and management of employee compensation and benefits programs in their respective organizations. Founded in 1955, ACA is governed by a Board of Directors elected from the membership, and it is committed to being the premier organization dedicated to excellence in total compensation. ACA serves educational, informational and research needs in compensation and benefits by promoting and sponsoring research activities, conducting education and certification programs and producing a variety of educational and informational publications.

Publication designed by Tom Largess, Maritz Inc.

© Copyright 1994 American Compensation Association and Maritz Inc. All rights reserved. This document may not be reproduced in any manner without the express written consent of the American Compensation Association and Maritz Inc.

For a complete copy of the research study, *Organizational Performance & Rewards – 663 Experiences in Making the Link,* or additional copies of this Executive Summary, please contact:

American Compensation Association
14040 N. Northsight Blvd.
Scottsdale, AZ 85260
Customer Service: 602/922-2020
FAX: 602/483-8352

Acknowledgments

This project would not have been possible without the 663 survey respondents who generously provided the facts upon which the research results are based.

Financial support as well as research expertise was provided by the past and current member organizations of the Consortium for Alternative Reward Strategies Research.

Present Consortium Members

AlliedSignal Inc.
Linda Salokas, Director, Compensation and Benefits

American Compensation Association
David Nurenberg (Exxon), Chairman, Executive and Variable Compensation Committee (member, CARS Board of Directors)
Jesse M. Smith Jr., CAE, CCP, Executive Director

Federal Express Corp.
Judith Edge, Manager, Compensation
Jack Henderson, Senior Compensation Advisor

Maritz Inc.
Jerry McAdams, CCP, Vice President, Performance Improvement Resources (member, CARS Board of Directors)

Motorola
Maggi Coil, CCP, Director, Compensation

Motorola SPS
Cathe Johnson, CCP, Director, Human Resources & Training (member, CARS Board of Directors)

Ohio State University
Robert Heneman, Ph.D., Director, Graduate Programs in Labor and Human Resources (member, CARS Board of Directors)

Texas Instruments Inc.
Jan Vernon, Corporate Compensation Manager (member, CARS Board of Directors)

The Travelers Insurance Cos.
Georgian Lussier, Director, Compensation

Past Consortium Members

GTE
Ike Greenspan, Director, Compensation

Monsanto Co.
Elizabeth J. Hawk, CCP, Senior Consultant

Present Advisory Board Members

Center for Effective Organizations
Edward E. Lawler III, Ph.D., Director (University of Southern California)

Center for Workforce Effectiveness
Marc J. Wallace Jr., Ph.D., CCP, Partner

Hay Management Consultants
Steve Gross, Vice President and Managing Director
Robert C. Oschner, Director of Compensation

Hewitt Associates
Terry Walker, Ph.D., Consultant
KPMG Peat Marwick
Steve Berman, National Practice Director, ARS
The Roth Group
Robert J. Butler, CCP, Principal
Rutgers University
Charles Fay, Ph.D., CCP, Associate Professor, Institute of Management and Labor Relations
Sibson & Company Inc.
Elizabeth J. Hawk, CCP, Senior Consultant (member, CARS Board of Directors)
Society for Human Resource Management Foundation
Richard W. Beatty, Ph.D., Professor of Human Resource Management, Rutgers University
Towers Perrin
Diane Gherson, Consultant
Washington University
Todd R. Zenger, Ph.D., Assistant Professor of Organization and Strategy
William M. Mercer Inc.
Sharon A. Tucker, Ph.D., Senior Compensation Consultant
The Wyatt Co.
Jamie Hale, CCP, Principal
Kathleen A. McNally, Ph.D., Consultant

Past Advisory Board Members

William M. Mercer Inc.
Linda K. Ison, CCP, Principal
Towers Perrin
Jane Bjorndal McAdams, Consultant

The American Compensation Association supported the project by providing financial and administrative resources. Our special thanks to the ACA leadership, membership and headquarters staff.

Our thanks also to Robert W. Miller, Executive Director, Compensation and Benefits, Pacific Telesis Group, and Past Chair of the Executive and Variable Compensation Committee, ACA, and Linda Salokas, Director of Compensation and Benefits, AlliedSignal Inc., for their unique contributions.

Long hours and dedicated support from analysts, programmers and administrators made this project successful. Those who contributed far beyond the call of duty include Ann Benson, Leila Cole, Layne Friedman, John Lapham, Tom Largess, Mindi McCoy, Marc Morris, Gloria Muia, Dan Tang, Charles Walker and Gina Wild of Maritz Inc. ACA staff contributors included Betty Laurie, Don Griffith, Patricia L. Llantino, CCP, Michael Bennett and Ronnie Kurtin Cummins, CCP.

The primary researcher, writer and stable presence is Donna Wahlig. Without her hard work, skill and intelligence, this report could not have become a reality.

Jerry L. McAdams, CCP Project Director Maritz Inc.	Elizabeth J. Hawk, CCP Project Director Sibson & Company Inc.

WRITTEN STATEMENT FOR TESTIMONY BEFORE THE

SUBCOMMITTEE ON REGULATION, BUSINESS OPPORTUNITIES, AND TECHNOLOGY
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

July 15, 1994

Douglas L. Kruse

Associate Professor of Human Resource Management
School of Management and Labor Relations
Rutgers University

and

Research Associate
National Bureau of Economic Research

I'm pleased to offer testimony on the research that I and others have done on the effects of profit sharing in business. Employee profit-sharing plans have attracted attention for their potential to improve economic performance and job security. Research has focused on two principal theories about the effects of profit sharing:

(1) The "productivity theory"--that group incentive plans like profit sharing and gainsharing can improve productivity by encouraging workplace cooperation, worker effort, and sharing of ideas and information to increase both quantity and quality of output;

(2) The "stability theory"--that profit sharing can change incentives to hire and retain employees, leading to lower unemployment and to greater employment and output stability for firms and the economy as a whole.

There has been an upsurge of empirical research on profit sharing in the past decade, since both of these theories are central to issues of economic performance, security, and the standard of living. This testimony will review the evidence on the effects of profit sharing (fully summarized in my recent book--Kruse, 1993), and discuss the role that public policy may usefully play.

How much profit sharing is there in the United States? Between one-sixth and one-fourth of American businesses and employees participate in some form of explicit profit sharing in which a portion of employee compensation is tied to the current profitability of the firm (U.S. Bureau of Labor Statistics, 1992; U.S. Chamber of Commerce, 1992; these and other sources are summarized in Kruse, 1993). The prevalence does not vary greatly by firm size or occupational group but is lower among unionized employees and higher in companies with publicly traded stock (presumably because profitability is already public information in these companies, whereas private companies may be reluctant to establish profit sharing for fear of disclosing profitability to competitors and union organizers). Several sources indicate slow growth of profit sharing in the early 1980s (often tied to union wage concessions) but report stabilization since that time. Internationally, there has been substantial interest in profit sharing in Europe and elsewhere, but few data exist on actual incidence (Blanchflower 1991; Florkowski 1991; Uvalic 1990).

Evidence on Productivity Effects of Profit Sharing

Does profit sharing improve company performance? For over a century there have been claims that it does, by encouraging workers to cooperate with each other and management, share ideas and information, and monitor and encourage co-workers. This theory has received new attention in the past two decades given the slowdown in productivity growth in the U.S. (which averaged only 1.2% per year in the 1970's and 1980's, following growth of almost 3.0% per year between

World War II and 1970).[1]

It is not obvious from theory that a system such as profit sharing will improve productivity. While profit sharing is often viewed positively as a way to align the interests of employers and employees, economists and others have often been skeptical of the potential impact of group incentives such as profit sharing or gainsharing on employee performance, due mainly to the weak link between individual effort and reward in large groups. This has come to be known as the "1/N problem"--if there are N workers in a firm, each worker shares on average only 1/N of the extra profit generated by his or her extra effort. In a small group of workers this may not represent a large drawback, but in a firm with hundreds or even thousands of employees it would seem to be far more serious. Economic theory nonetheless admits the possibility that this problem may be overcome, even in large groups, by the creation and sustenance of high work norms with mutual monitoring and peer pressure among workers to discourage "shirkers", fostered by appropriate policies and climate in the firm. Apart from the 1/N problem, some theorists have argued that by decreasing the amount of profits going to owners, profit sharing may dampen the incentives of owners and managers to supervise efficiently; in addition, it is often suggested that workers are risk-averse and will tend to dislike and avoid systems such as profit sharing where compensation may be variable. Therefore it is not obvious that systems such as profit sharing will have favorable effects, raising the importance of empirical investigation to help sort out the competing claims and counter-claims about its effects.

What is the evidence on the company performance effects of profit sharing? In the past 15 years there have been 30 econometric studies that have shed light on this, using data from over 7000 companies. It is important to note that these studies use data on actual firm performance (not just the opinions of managers or others), and attempt to control carefully for other factors that affect productivity (such as a firm's capital stock or general productivity levels and trends in the industry).[2] Some studies measure profit sharing as the presence or adoption of a profit-sharing plan, while others measure some of the plan features (such as size of profit-sharing bonus or the percent of employees covered). A wide variety of companies is represented in the data sources, with representation from many industries, firm sizes, types of ownership, and countries (including 10 U.S. studies covering more than 5200 firms). The attachment contains an overview of these 30 studies, including Table 3.1 from my book that summarizes 26 of these studies, along with the new results from my book and three more studies that have appeared since the book was published last fall.

The combined results from these 30 studies are striking. Of 345 estimates of the direct relationship between profit sharing and productivity, 92% are

---

[1] Economic Report of the President (Washington: U.S. Government Printing Office, 1992), Table B-44.

[2] In contrast, studies that use simple comparisons between profit-sharing and non-profit-sharing firms are reviewed in Weitzman and Kruse (1990). These comparisons are almost uniformly favorable toward profit sharing.

positive, and 55% are strong enough to rule out sampling error at a high level of confidence. If there really is no relationship between profit sharing and productivity, the odds of finding such results from independent studies are infinitesimally small. There is little doubt of a generally positive relation.

What is the size of the productivity differential associated with profit sharing? The effect sizes vary considerably among the studies, with an average of 4.5% and most estimates falling in the 3% to 11% range. This is large enough to be noteworthy (particularly in light of the 1.2% annual productivity growth in the U.S. since 1973), but not so large as to be implausible (since it is believable that extra cooperation and ideas could easily raise productivity by this much, while estimates of 50% or 100% higher productivity would raise the question of why profit sharing hadn't already been adopted by every firm in the economy).

The evidence that there is a strong positive link between profit sharing and productivity, however, does not establish causality. In several studies, this has been addressed in part by pre/post comparisons of firms adopting profit sharing (to examine the possibility that profit-sharing firms had high productivity even before profit sharing). For example, I sought to address this and other concerns by collecting new survey data from 500 companies with publicly-traded stock--half with profit sharing--and matching this to corporate performance data over the 1970-91 period (which public companies must provide). For companies that adopted profit-sharing plans within this period, I could track company performance for several years before and after this adoption. I could also statistically control for industry differences and the influence of regular pension plans, ESOPs, and other human resource policies used by the companies.

Contrary to the idea that profit-sharing companies were simply more productive to begin with, adoption of profit sharing was associated with an average 3.5-5 percent increase in productivity that was maintained with no general upward or downward trend (that is, no "honeymoon" effect that died away). The size of these increases corresponds to the average productivity differentials found in other studies, as noted above. Simply adopting profit sharing, though, was not found to be automatically associated with productivity increases: there was a wide dispersion in results, with one-fourth to one-third of the adopters having no productivity increase beyond that predicted by other terms in the production function. Consistent with common beliefs about profit sharing, the productivity effects were found to be largest for small companies (where there is less dilution of individual incentives), for cash plans (where the reward is immediate and not put into a pension trust[3]), for plans where the profit share was a larger portion of employee pay, and for plans where the profit share was more highly related to profits. The estimates also discounted the idea that profit sharing is simply acting as a proxy for other human resource policies or for higher management quality, or that there is selection bias induced by the timing of adoption. These results dovetail with other positive findings on

---

[3] The productivity effects appear to be larger for cash plans, but several studies clearly show smaller but significant positive effects for deferred plans as well.

productivity effects of profit sharing in U.S. public companies (Kruse, 1992; Kumbhakar and Dunbar, 1993; Mitchell, Lewin, and Lawler, 1990; Shepard, Forthcoming).

Therefore there is strong evidence not only that profit-sharing companies have higher productivity levels than do comparable non-profit-sharing companies, but also that companies adopting profit sharing tend to have productivity increases beyond what would be predicted by other company changes or industry trends. The strength of the relationship is noteworthy in part because few areas of economics have such consistency of findings--even on basic economic principles such as the effect of a minimum wage increase. While the accumulated research has clearly established a positive link between profit sharing and productivity, there has been very little information on how profit sharing may be combined with other human resource policies or other firm characteristics to work most effectively.

Evidence on Stability Effects of Profit Sharing

Can profit sharing lead to greater economic stability, and lower layoffs and unemployment? There was substantial attention paid in the mid-1980's to the "share economy" theory developed by Marty Weitzman of Harvard University (Weitzman, 1984). This theory concludes that, if part of employee compensation is tied to company profits (rather than all coming in the form of fixed wages and benefits), a profit-sharing firm will have a lower likelihood and size of layoffs when demand for the firm's products decline. If implemented broadly throughout the economy, the lower level of layoffs and unemployment should help to stabilize consumer purchasing power and economic activity, greatly decreasing the magnitude of the business cycle and the economic losses of recessions. This testimony will very briefly touch on the underlying theory, and focus more upon the empirical evidence (for discussion of the theory, see: Weitzman, 1984; my summary in Kruse, 1993; and citations within).

The key to the theory that profit sharing increases stability is that, in making decisions over how many employees to have at any point in time, employers pay attention only to the fixed wages and benefits that must be paid to each employee. The profit share that is paid to employees is essentially ignored by the employer as a cost of labor, and is seen rather as an incidental "tax" on overall profits that (in contrast to higher fixed wages) does not decrease desired employment levels. The prediction of the theory is that, because firms are not viewing the profit share as a fixed obligatory cost of employing labor, profit-sharing firms will be generally eager to hire new workers and reluctant to lay off existing workers. If there is widespread use of profit sharing throughout the economy, Weitzman's theory predicts that:

> A share system looks very much like a labor-shortage economy. Share firms ever hungry for labor are always on the prowl--cruising around like vacuum cleaners on wheels, searching in nooks and crannies for extra workers to pull in at existing compensation parameter values (Weitzman, 1984: 98-9).

In such a "share system" the eagerness of firms to hire workers should result

in a full-employment economy (with little or no involuntary unemployment, but still frictional unemployment as workers enter the workforce or move between jobs). The business cycle should be much less severe, with fewer layoffs and more maintenance of consumer purchasing power.

The stability theory relies on the profit share substituting in part for fixed wages and benefits--in other words, that profit sharing not be a pure "gift" to employees. It is a common mistake, however, to assume that this means the fixed wage must be lowered in a profit-sharing firm for the theory to work. If profit sharing leads to higher workplace performance (in line with the productivity results discussed), regular fixed wages and benefits may be just as high in a profit-sharing firm as in a fixed-wage firm, while the profit-sharing workers receive higher total pay because of the added profit share. In this case the stability theory would still apply because the profit share is not simply a pure gift to employees, but is the reward for better performance. Unlike the fixed-wage firm, the profit-sharing firm would maintain a strong incentive to hang onto its workers if product demand goes down. (Put more technically, even with no change in fixed wages, the unit labor cost apart from the profit share would be lower in the profit-sharing firm, leading to fewer layoffs than in a fixed-wage firm if the value of output goes down.)

Is there a conflict between the productivity and stability theories of profit sharing--that is, is it possible to get either higher productivity or greater stability, but not both? As the above discussion illustrates, there may be no conflict at all--if employees are more productive partially as a result of profit sharing, and are rewarded with higher income through the profit share, the stability theory predicts that they should be more immune to layoffs if the firm's product demand goes down. Several theorists have pointed out that, under the stability theory, employees would want to control the size of their work group, and may resist the hiring of new employees who would share in the profits and leave less for current employees. If current employees can restrict new hires (or put pressure on management not to hire), then the "vacuum cleaner" effect of the stability theory breaks down. This does not, however, necessarily present a conflict with the productivity-enhancing potential of profit sharing, and in fact the stabilizing effects of profit sharing may be more likely in a workplace where profit sharing has helped increase productivity. Workers in a high-productivity workplace are less likely to be laid off, as noted above, and should be more willing to accept new hires in an expanding company, provided the new employees can be socialized into the higher work norms. Any resistance to new hires would be much more likely in a profit-sharing company with low or average productivity.

How should a profit-sharing plan be structured to enhance the stability of the company? The theory does not place strict limits. The only clear requirements are that the profit-sharing payments be related to overall firm performance, and that they not be a pure gift to employees in the absence of any change in workplace performance (as discussed above). The payments need not be related directly to profits, but may be related to revenues or operational measures (as in gainsharing plans) that reflect in some way the demand for the firm's products. In addition, the theory places no limits upon whether the payments be given directly to employees (cash plans) or be put in a pension trust (deferred plans). How large should the profit share be? This depends on the

underlying company variability. For the public companies I studied, the average employment cutback for non-profit-sharing firms in years when (inflation-adjusted) sales decreased was 4-5%. Based on the share economy theory, an average profit share of 10% would prevent layoffs in a situation where up to 5% of employees would be laid off by a fixed-wage firm.[4] When there are larger decreases in demand for the firm's products, the layoffs would be lower in a profit-sharing firm than in a fixed-wage firm, but a larger profit share would clearly be necessary to totally prevent layoffs.

What is the evidence on the stability effects of profit sharing? There have been 16 studies on the employment behavior of profit-sharing firms relative to conventional fixed-wage firms. While the productivity theory lends itself to fairly standard tests using a production function, there has been a much greater variety of techniques used to examine the stability theory, and the estimates are not as easy to summarize. In particular, there are difficulties in measuring the size of the product demand shocks faced by firms, the relationship of the profit share to regular wages, and the degree to which profit sharing should help with product demand shocks of different sizes.

The attachment contains an overview of the 16 studies to date (reproduced from Table 4.1 of my book). As can be seen the findings are dispersed, which may be traced in part to many difficulties in appropriately testing the theory. It is noteworthy, though, that almost all of the studies directly measuring firm stability have found some indications of greater stability for profit-sharing firms. In particular, the seven studies of U.S. firms are generally favorable to stabilizing effects of profit sharing (not in all tests, but in many of the tests). For example, Chelius and Smith analyzed survey data from almost 3000 small businesses and found that profit-sharing firms had smaller employment cutbacks when product demand went down. Gerhart found that, comparing firms with similar variability of overall sales, profit-sharing employees had more stable employment than did other employees, while I found that profit-sharing manufacturing firms were less likely than other firms to cut employment in the recessions of the mid-1970's and early 1980's. Bell and Neumark found that firms with union contracts implementing profit sharing had higher employment growth and more employment stability after profit sharing adoption, but the results were not strong enough to reject sampling error as a contributing factor.

The theory that profit sharing aids stability does not predict that it will do so in every situation, and the evidence indicates that there is no automatic connection between the use of profit sharing and the stability of a firm. In my recent study of 500 U.S. public companies, this was my conclusion from comparing firms before and after the adoption of profit sharing; however, I did find greater stability in certain circumstances. In particular, consistent with Weitzman's theory, I found favorable results in the firms where profit sharing did not appear to be simply a pure gift to employees, but instead resulted in better firm performance or some substitution with fixed wages and benefits. In these firms, prior to adopting profit sharing a decline in company sales led to typical employment cutbacks, but after adoption the same decline

---

[4] This assumes a labor demand elasticity of .5, which is close to the middle of empirical estimates.

led to almost no employment cutbacks.[5]

Therefore the limited research that is available strongly suggests that profit sharing may play a role in the employment behavior of firms, but does not provide a direct and clear answer to the question of how profit sharing affects employment stability. On the positive side, almost every study of employment stability finds some evidence of greater stability associated with profit sharing, and no study finds lower stability with profit sharing. On the negative side, however, there are a number of findings where the researchers did not find employment differences strong enough to rule out sampling error (that is, the observed differences were not statistically significant).

Profit Sharing and Public Policy

Is there a role for public policy in the development of profit sharing? It has been a subject of policy debates, proposals, and legislation in a number of countries (Uvalic 1990; Florkowski 1991). Current approaches by national governments (as noted by Florkowski, 1991), can be divided into four categories:

1. some form of mandatory profit sharing (in 13 countries, although enforcement is unclear),
2. tax incentives (in four countries),
3. advisory institutions (in one country--Denmark), and
4. nonintervention (in 29 countries).

The United States has tax incentives only for deferred profit-sharing plans, but this incentive is not particular to profit sharing since it exists for other types of pensions. Great Britain, in contrast, established tax incentives in 1987 specifically targeted to cash profit sharing (motivated in large part by its potential to decrease high unemployment levels, although there is no evidence on the effects of this legislation yet).

Do the theories that profit sharing can increase productivity and employment stability suggest a role for public policy? The public policy rationales are different for the two theories. It is not obvious that public policy is necessary or desirable under the theory that profit sharing increases productivity, since the gains from productivity improvement accrue to the company and the employees--there should be sufficient private incentives for profit-sharing adoption. Tax incentives might be used to encourage experimentation, as temporary incentives have sometimes been designed to encourage development and diffusion of new technologies. They are risky, however, since they are potentially costly and may encourage cosmetic schemes in workplaces where profit sharing is unlikely to have a positive impact. A different case for tax

---

[5]To illustrate, a sales decline of 10% resulted in an average estimated employment cutback of 7% for non-profit-sharing firms and firms prior to adopting profit sharing. After adoption, the firms where profit sharing seemed to partially substitute for fixed compensation had only a 1% employment cutback for a 10% sales decline, while other profit-sharing adopters had little change in responsiveness (Kruse, 1993: 136).

incentives can be built if there are structural barriers to the implementation of productivity-enhancing human resource policies--for example, if lenders are reluctant to provide capital for investments that are intangible and hard to monitor, or if unstable product markets raise the costs of participative arrangements that depend on stable work groups (Levine and Tyson 1990; Levine 1992).

A less costly and potentially very useful government role suggested by the productivity theory is to gather and disseminate information on how profit sharing can be used to increase productivity. Such an approach recognizes that this information may have a "public good" nature, creating a potential role for government similar to its dissemination of information through the agricultural extension system and sponsorship of research on alternative energy sources.[6]

Is there a clear role for public policy under the share economy theory? Yes, because the gains from employment stability are not only microeconomic (accruing to the profit-sharing firm and employees), but macroeconomic (accruing to the economy as a whole, as purchasing power is maintained without unemployment insurance or government assistance). Through increased stability in the labor and product markets, firms and workers throughout the economy should gain as more firms adopt profit sharing. The external benefits to government and the economy, if the stability theory is correct, would be justification for appropriate tax incentives (which was a large part of the rationale for Great Britain's adoption of tax incentives in 1987).

What public policies on profit sharing are justified? The accumulated empirical research on profit sharing, while it can only be one element of consideration, can shed light on the appropriateness of public policy.

The strength of the positive association between profit sharing and productivity, which exists across a wide variety of studies and samples of firms, naturally creates strong interest in whether government encouragement of profit sharing is a useful tool in fostering better economic performance. Tax incentives may be appropriate to encourage experimentation and diffusion, but they are risky and potentially costly. It is very likely that profit sharing should be combined with other human resource policies to achieve the best performance, and the incentives should apply to the combination of policies rather than one in isolation (such as employee participation plans, information-sharing, and voting rights for any stock ownership through deferred plans). Accumulated research has firmly established a generally positive link between profit sharing and productivity, but has provided few clues on the best conditions for positive productivity effects. At this point the less costly role of information collection and dissemination has stronger justification.

The share economy theory creates a stronger case for tax incentives to

---

[6] Florkowski (1991: 111) recommends the creation of a "national commission of government, business, and labor representatives . . [which] could act as a short-term catalyst by mobilizing expertise, serving as an information clearinghouse, and engaging in research--roles similar to those performed by the National Institute of Occupational Safety and Health".

encourage profit sharing, because of the macroeconomic benefits. The accumulated empirical evidence on employment behavior does not yet make a clear case for such incentives, although it should be noted that evidence rarely points in one direction on policy issues (even on straightforward economic predictions such as the employment effects of a minimum wage). Since favorable tax treatment is already given to deferred profit sharing, the case is strongest to extend favorable treatment to cash plans. If this is done, it should be conditioned on two things:

1) The cash plan should be explicitly tied to some measure of firm performance that reflects demand for the firm's products. This may be profits, revenues, or some operational measure.

2) The plan should provide a substantial profit share. An average of at least 5%, and preferably 10%, of compensation should come in the form of profit sharing. This increases the likelihood both of positive productivity effects and of increased stability and decreased layoffs.

Therefore my principal recommendation is for strong government efforts to collect and disseminate information on how profit sharing and gainsharing plans can be used to increase performance and prevent layoffs. If tax incentives are used, they should be directed toward cash plans that are explicitly linked to some measure of firm performance, and constitute a sizeable portion of employee pay (an average of 5% at a minimum).

The potential payoffs for an increased focus on profit sharing and gainsharing are high, since research points toward a potentially strong contribution of these plans in fundamental issues of economic performance--productivity, unemployment, and macroeconomic stability. Thank you for the opportunity to present my views and evidence on this important subject.

References

Biagioli, Mario. "An Econometric Investigation of Employee Financial Participation in Enterprise Results in a Sample of Large Italian Firms," Draft, University of Modena, Italy, 1993.

Blanchflower, Daniel. "The Economic Effects of Profit Sharing in Great Britain." International Journal of Manpower 12, no. 1 (1991): 3-9.

U.S. Bureau of Labor Statistics. Employee Benefits in Medium and Large Firms, 1991. Washington, D.C.: Government Printing Office, 1992.

U.S. Chamber of Commerce. Employee Benefits. Washington, D.C.: Economic Policy Division, Chamber of Commerce of the United States, 1992.

D'Art, Daryl. Economic Democracy and Financial Participation: A Comparative Study. New York: Routledge, 1992.

Florkowski, Gary W. "Profit Sharing and Public Policy: Insights for the United States." Industrial Relations, 30, no. 1 (Winter 1990): 96-115.

Jones, Derek C. "The Productivity Effects of Employee Ownership Within Command Economies: Evidence from Poland," Managerial and Decision Economics, Vol. 14, 1993, pp. 475-485.

Kaden, Lewis B., and Lee Smith. America's Agenda: Rebuilding Economic Strength. Armonk, N.Y.: M.E. Sharpe, 1992.

Kumbhakar, Subal C., and Amy E. Dunbar, "The Elusive ESOP-Productivity Link," Journal of Public Economics, Vol. 52, 1993, pp. 273-283.

Kruse, Douglas L. "Profit Sharing and Productivity: Microeconomic Evidence from the United States," Economic Journal, Vol. 102, No. 410, January 1992, pp. 24-36.

-----. Profit Sharing: Does It Make A Difference? Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1993.

Levine, David. "Public Policy Implications of Imperfections in the Market for Worker Participation." Economic and Industrial Democracy 13, no. 2 (May 1992).

Levine, David, and Laura D'Andrea Tyson. "Participation, Productivity, and the Firm's Environment." In Paying for Productivity: A Look at the Evidence, edited by Alan S. Blinder. Washington, D.C.: Brookings Institution, 1990.

Mitchell, Daniel J.B. "Profit Sharing and Employee Ownership: Policy Implications." Working Paper Series 251, Institute of Industrial Relations, University of California-Los Angeles (May 1993).

-----, David Lewin, and Edward E. Lawler III. "Alternative Pay Stems, Firm Performance, and Productivity." In Paying for Productivity: A Look at the Evidence, edited by Alan S. Blinder. Washington, D.C.: Brookings

Institution, 1990.

Shepard, Edward M. "Profit Sharing and Productivity: Further Evidence from the Petrochemicals Industry." Industrial Relations. Forthcoming.

Uvalic, Milica. The PEPPER Report: Promotion of Employee Participation in Profits and Enterprise Results in the Member States of the European Community. Prepared for the Commission of the European Communities, Brussels. San Domenico, Italy: European University Institute, June 1990.

Weitzman, Martin L. The Share Economy. Cambridge, Mass.: Harvard University Press 1984.

Note: See Kruse (1993) for sources of studies cited in Tables 3.1 and 4.1 that were reproduced in the attachment.

Attachment to Kruse testimony: Summaries of empirical studies on effect of profit sharing on productivity (Table 3.1) and employment stability (Table 4.1)

PROFIT SHARING

Does It Make A Difference?

The Productivity and Stability Effects of Employee Profit-Sharing Plans

Douglas L. Kruse
Rutgers University

1993

W.E. UPJOHN INSTITUTE for Employment Research
Kalamazoo, Michigan

Table 3.1 Econometric Studies of Profit Sharing

Authors of the studies	Source of data	Productivity measure	Profit-sharing measure	Number of coefficients reported	Percent of coeffs. <0	Percent of t-stats. >+2
1. Bhargava 1991	150 British firms with public stock, 1978 to 1989	Profits defined as rate of return on fixed capital	Dummy for firms with profit sharing, current and lagged	10 current 10 lags	0.0 100.0	40.0 0.0
2. Bradley and Smith 1991	86 U.S. firms in computer industry with public stock, 1986-88	Revenues	Dummy for profit-sharing firms, plus interactions w/labor	2 main effects 3 interactions	0.0 33.3	100.0 33.3
3. Cable and Fitzroy 1980a, 1980b	42 West German firms members of the AGB from 1974 to 1976	Value-added	Total profits distributed to workers	3	33.3	33.3
4. Cable and Wilson 1989	52 U.K. firms in engineering, from 1978 to 1982	Value-added	Dummy for profit-sharing firms, interacted with firm characteristics	[a]	[a]	[a]
5. Cable and Wilson 1990	61 West German firms in 1977; 62 West German firms in 1979	Value-added	Dummy for profit-sharing firms, interacted with firm characteristics	[a]	[a]	[a]
6. Cahuc and Dormont 1992	565 French manufacturing firms, 1986-89	Value-added	Profit-sharing payments divided by base wage	12	0.0	83.3
7. Carstensen, Gerlach, and Hubler 1992	136 German manufacturing firms in 1989	Value-added, profits per employee, and return on capital	Dummy for profit sharing, profit share/profits, profit share per employee	21[a]	61.9	14.3
8. Conte and Svejnar 1988	40 U.S. firms (period not reported)	Value-added	Dummy for firms with profit sharing	6	0.0	33.3
9. Cooke 1993	1,173 U.S. manufacturing firms, 1989	Value-added per employee, and sales per employee	Dummy for profit sharing/gainsharing, interacted with union status and work teams	8 interactions[a]	0.0	100.0
10. Defourney, Estrin, and Jones 1985	440 French cooperatives in 1978; 550 French cooperatives in 1979	Value-added	Profits distributed to workers per head	14	0.0	64.3
11. Estrin, Jones, and Svejnar 1987	Cooperatives in France (550 in 1978-79), Italy (150 in 1976-80), and Britain (50 over 1948-68)	Value-added	Profits distributed to workers per head	11	0.0	81.8
12. Fitzroy and Kraft 1986	61 West German firms in 1977; 62 West German firms in 1979	Profits defined as cash flow divided by assets	Profits distributed to workers per head	2	0.0	100.0
13. Fitzroy and Kraft 1987	Same as above	Total factor productivity (residual of a Cobb-Douglas estimation)	Profits distributed to workers per head	2	0.0	100.0
14. Fitzroy and Kraft 1992; Kraft 1991	Same as above	Value-added	Dummy for profit sharing, alone and interacted with capital and employment	6 main effects 3 interactions[a]	0.0 33.3	83.3 0.0

Authors of the studies	Source of data	Productivity measure	Profit-sharing measure	Number of coefficients reported	Percent of coeffs. <0	Percent of *t*-stats. >+2
15. Florkowski 1988	3 U.S. profit-sharing companies (monthly data)	Value-added per worker	Intercept and slope effects before and after the plan introduction or modification	6	16.7	16.7
16. Jones 1982	From 46 to 30 British cooperatives over the period 1948-68	Value-added	Individual bonus to labor	52	5.8	40.4
17. Jones 1987	50 British cooperatives in the retail sector in 1978	Gross margin	Surplus distributed to workers as dividend	2	0.0	0.0
18. Jones and Kato 1992b	100 Japanese firms over 1973-80 period	Value-added	Profit-sharing bonus per employee, and divided by base wage, alone and interacted with capital, labor, and ESOP presence	15 main effects 59 interactions[a]	0.0 45.8	73.3 32.2
19. Jones and Pliskin 1991b	70 firms in clothing, footwear, and printing over the period 1923 to 1968	Real sales	Size of bonus and dummy for bonus, alone and interacted with capital, labor and employees on board	12 main effects 27 interactions[a]	8.3 55.6	50.0 3.7
20. Jones and Svejnar 1985	316 Italian cooperatives from 1975 to 1978; 315 Italian cooperatives from 1975 to 1980	Value-added	Profits distributed to workers per head	6	0.0	100.0
21. Kim 1993	183 U.S. companies with public stock, 1986	Return on assets	Dummy, percent of workers covered, and bonus/labor costs	15	6.7	20.0
22. Kruse 1988, 1992	2,976 U.S. companies with public stock, 1971-85	Sales per employee	Dummy for firms with profit sharing; percent of employees covered by profit sharing	76	5.3	68.4
23. Lee and Rhee 1992	Industry data from South Korea, 1972-89	Index of industrial production/total labor hours	Profit-sharing bonus divided by wage	7	0.0	85.7
24. Mitchell, Lewin, and Lawler 1990	495 U.S. business units, 1983-86	Sales per employee; return on investment; return on assets	Dummy for firms with profit sharing	12	0.0	83.3
25. Shepard 1986, forthcoming	20 U.S. chemical firms from 1975 to 1982	Value-added	Dummy for firms with profit sharing; profits distributed to workers per head; ratio of profit sharing to fixed compensation	16	0.0	81.3
26. Wadhwani and Wall 1990	96 U.K. firms from 1972 to 1982	Real sales	Dummy for firms with profit sharing, and interaction w/capital	1 main effect 1 interaction[a]	0.0 0.0	0.0 100.0
Total main effects, where no interactions or lags appear[a]				265	8.7	57.4

a. For the study using lags (number 1), all 10 specifications indicate positive effects of adopting and maintaining profit sharing. For the eight studies using interactions, six (numbers 4, 5, 9, 14, 19, 26) indicate that profit sharing is associated with higher performance at mean values of the interacted variables (the productivity difference is 3 to 8 percent in study 4, 20 to 30 percent in study 5, and 1.4 to 28.3 percent in study 14). Study 2 reports positive associations only for small firms, and study 18 reports positive effects only when profit sharing is associated with employee stock ownership.
b. Estimates with industry controls.

Table 3.1 addendum: Additional Evidence on Profit Sharing and Productivity

27. Biagioli 1993
    Data source: 179 Italian companies, 1987-91
    Productivity measure: Value added
    Profit-sharing measure: Existence or adoption of profit sharing
    No. of coefficients reported: 12
        Percent less than zero: 0%
        Percent with T-stat.>2: 67%

28. Jones 1993
    Data source: 181 Polish cooperatives, 1976-78
    Productivity measure: Value added
    Profit-sharing measure: Bonus per worker
    No. of coefficients reported: 6
        Percent less than zero: 0%
        Percent with T-stat.>2: 67%

29. Kruse 1993
    Data source: 500 U.S. public companies, 1970-91
    Productivity measure: Value-added and sales per worker
    Profit-sharing measure: Adoption of profit sharing
    No. of coefficients reported: 58
        Percent less than zero: 8.6%
        Percent with T-stat.>2: 36.2%

    (Significant adoption effects of 3.5-5%, concentrated among cash plans and plans with profit-based or discretionary formulas)

30. Kumbhakar and Dunbar 1993
    Data source: 123 U.S. public companies adopting profit sharing or ESOP, 1982-87
    Productivity measure: Sales
    Profit-sharing measure: Adoption of profit sharing
    No. of coefficients reported: 4
        Percent less than zero: 0%
        Percent with T-stat.>2: 100%

    (Significant growth effects of 3.9-4.6% per year for first several years after adoption)

Table 4.1 Profit Sharing and Employment Stability Studies

Study	Data source	Unit of analysis	N	Time period	Profit-sharing measures	Main results
Disaggregated data						
Bell and Neumark 1993	U.S. publicly traded firms with union contracts	Firm	204	1978-87	Dummy for PS negotiated in union contract	Weakly favorable: adoption of PS in union contract associated with higher employment growth and lower employment variability, though effects not statistically significant
Bradley and Estrin 1990	Large British retail chains (one with PS)	Firm	5	1971-85 (balanced)	PS dummy and B/W	Mixed: PS firm had higher employment than others, and B/W positively related to employment changes, but similar employment changes over the business cycle
Chelius and Smith 1990	(1) U.S. small businesses	Firm	2997	1987	PS dummy and B/W (cash and deferred plans)	Generally favorable: PS firms have smaller employment decreases when sales decline; result is stronger for PS dummy than for B/W
	(2) Quality of Employment Survey	Persons	404	1977	PS dummy	Favorable: workers in PS plans were less likely to be laid off in previous year
Estrin and Wilson 1989	British firms in metalworking and engineering	Firm	52	1978-82 (balanced)	PS dummy and B/W	Generally favorable: authors reject hypothesis that PS payments are part of the marginal cost of labor

Study	Data source	Unit of analysis	n	Time period	Profit-sharing measures	Main results
Finseth 1988	U.S. publicly traded firms in manufacturing	Firm	132	1971-85 (balanced)	PS dummy and B/W (both cash and deferred plans)	Mixed: B/W more responsive than W to changes in profits, mixed results on stability (PS increases employment when profits/L is used as demand measure)
Fitzroy and Vaughan-Whitehead 1989	French manufacturing firms	Firm	116	1983-85 (balanced)	PS dummy and profit share per worker	Mixed: profit share per worker negatively related to employment, but cash PS firms maintain higher employment in downturn
Florkowski 1991	U.S. publicly traded firms	Firm	516	1971-87 (balanced)	PS dummy	Mixed: pre/post comparisons for profit-sharing adopters found greater postadoption stability only in 5- and 6-year comparisons
Gerhart 1991	Exempt employees, U.S. business units	Firm	156	1981-85 (unbalanced)	B/W, net of human capital and job factors	Favorable: higher B/W associated with lower variability of exempt employment, controlling for variability of firm performance
Jones and Pliskin 1989	British firms in printing, footwear, and clothing	Firm	127	1890-1975 (unbalanced)	PS dummy and B/W	Mixed: PS dummy associated with lower employment, but B/W coefficient sensitive to whether measures of worker part. are included
Kraft 1991	West German firms	Firm	62	1977, 1979	PS dummy	Favorable: PS firms had lower dismissal rate
Kruse 1991a	U.S. publicly traded firms	Firm	1383	1971-85 (balanced)	PS dummy, and percent of workers covered (deferred plans)	Generally favorable: PS associated with more stability in the face of negative demand shocks in manufacturing, but not in nonmanufacturing
Kruse 1991b	U.S. publicly traded firms	Firm	568	1980-86 (unbalanced)	B/W	Generally favorable: PS payments, unlike wages and defined benefit payments, do not appear to be treated as part of marginal cost of labor
Wadhwani and Wall 1990	British publicly traded firms	Firm	101	1972-82 (balanced)	PS dummy and B/W	Unfavorable: Both PS measures statistically insignificant, but magnitudes indicate B/W depresses employment more than wages do
Aggregate data						
Estrin, Grout, and Wadhwani 1987	Japanese aggregate data	Aggregate economy		1959-83	B/W	Unfavorable: wages and bonuses have slightly positive, insignificant coefficients, when controlling for capital and not output (in contrast to Freeman and Weitzman)
Freeman and Weitzman 1987	Japanese aggregate and industry-level data	Aggregate economy and manuf.		1959-83	B/W	Favorable: Bonus appears to have profit-sharing components, and, unlike wages, relates positively to employment (controlling for output changes)

NOTES: PS = profit sharing, B/W = profit-sharing bonus/wage, W = wage.

TESTIMONY OF JOHN L. ZALUSKY
HEAD OF
THE OFFICE OF WAGES AND INDUSTRIAL RELATIONS
DEPARTMENT OF ECONOMIC RESEARCH
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
TO
THE SUBCOMMITTEE ON REGULATION, BUSINESS OPPORTUNITIES, AND TECHNOLOGY OF THE HOUSE COMMITTEE ON SMALL BUSINESS ON PERFORMANCE BASED PAY SYSTEMS

JULY 15, 1994

Mr. Chairman, we appreciate the opportunity to discuss and present the views of the AFL-CIO on performance based pay systems. As you know, the labor movement has had well over a century of experience with a wide rang of performance based pay plans, therefore, I will be glad to answer any questions on particular plans that I am familiar with. But, the experiences has been diverse and the plans varied. Your hearing raises the question about whether government policies should be used to anchorage performance based pay systems. The AFL-CIO believes the these issues are best left to collective bargaining and no new federal programs should be undertaken in this area.

Labor's experience includes, commission sales plans, direct incentive plans, for instance, piece work, standard hour plans; merit pay plans; gain-sharing plans such as the Eddy-Rucker, Scanlon and Improshare plans; profit-sharing plans, stock ownership plans, and plans based on the price of the commodity. Sometimes a work force will have two or three plans stacked on top of one another. All of these plans are complex, and too often, remote from what workers do each day. Many, as a result, do little to motivate productivity and quality improvement – which are correctly national public policy goals.

Some gain-sharing plans can be made to look very much like a profit-sharing plan and some profit-sharing plans are called gain-sharing, eg., the Machinist's negotiated plan with McDonald - Douglas. Some of these systems have been initiated by the union and collectively bargained, eg., profit-sharing in the auto industry and piece work in the garment industry. But most performance based pay plans have been imposed in a one sided way by management. Some of these plans are built around labor management participation, but many have had labor/management participation tacked on as an afterthought, and most have no worker voice at their inception or in their operation. It is extremely important that workers have a voice in any incentive plan that seeks to motivate workers through variable compensation.

The type of plan and what it achieves depends on the nature of the enterprise and what the goals are. Some work in the public sector while others would not work at all. Some work better in an office than others. Other plans work better with groups or teams of 50 to 100, while some plans can be applied to much larger firms. Others plans, like the Eddy-Rucker gain-sharing plan which is based on value added, will not work in a vertically integrated enterprise. On the other hand, the Scanlon plan can be fitted to such a firm with ease. Some plans motivate better and in a more predictable way than others. However, they all have one characteristic that policy makers must consider.

All variable compensation plans shift risk from managers and stockholders to wage earners. If one believes in motivating management through the risk of the market place,

then the amount of risk is shifted away from management to workers and the way it is done becomes critical. Workers can not afford much risk of income variation. Thus, very few union negotiated variable compensation plans put more than 25% of a worker's take home pay at risk and all are designed to keep variation to a minimum. Rate cutting is challenged and the policy of good and fair base wages are an essential element in a union negotiated flexible compensation plan.

Thus, if Congress is considering tax advantages for a flexible compensation plan, it must assess what goals it wants to achieve, how to assure that a particular plan will not put too much worker income at risk, and how to insure that workers will be treated fairly.

Profit-sharing plans, as has been suggested, work well as a variable benefit, but have important limitations as a motivator of productivity or quality improvement. However, they do shift risk from management to workers. Its applicability as a national plan for productivity and quality improvement is particularly questionable.

First, a large segment of the work force would be excluded -- all state, local, and federal government employees, and all of the employees of nonprofit firms such as hospitals and schools.

Second, the nexus between what one does today, and the reward, is far removed with nearly all profit-sharing plans. In fact, there may be no connection and this can

produce negative incentives[1]. Some of these negative effects are caused because management makes a poor decision that adversely affects profits and therefore employee earnings. For example the decision to produce a new Coke-Cola or the public relations statements dealing with the finding of glass in Gerber's baby food. Additionally, profits may go up or down because of national policy statements, changes in interest rates, the value of the dollar against other currencies and a multitude of factors totally unrelated to what a worker does or can effectively influence. If profit-sharing returns to employees can go up or down regardless of what a worker does, not only is the linkage between enterprise success, employee commitment and productivity weakened, the employee may feel further removed from the firm's success and decision making processes than they would without profit-sharing.

Finally, profits are easily manipulated, and even when they are not, employees wonder if they are. The real and imagined manipulation is particularly acute with firms that are not publicly traded. There have been many examples of abuse of employee profit-sharing in the pension area with defined contribution retirement benefit plans.

---

[1]Colloquy between Paul A. Allaire, Chairman and CEO, Xerox Corporation and JM (Mac) Booth, President and CEO, Polaroid Corporation, Boston Regional Hearing, Commission on the Future of Worker-Management Relations (January 5, 1994). Both discussed profit-sharing and noted that their firms did not use profit-sharing because they were concerned about negative incentives.

The AFL-CIO calls Congress's attention to the fact that this nation has had a long history of firms that have used cash profit-sharing. And, it has never really caught on, except as a defined contribution retirement plan.

One of the first questions that needs to be answered is; is the national benefit enough to off-set its cost? If only 10 million workers (a conservative estimate) were eligible and took an individual tax deduction of $1,000 per year, it would cost the federal budget $2 billion per year or $10 billion over 5 years. Would profit-sharing generate enough new review through improved productivity and economic growth to off-set this cost? The AFL-CIO is not aware of any credible studies that indicate this would be the case.

Congress, under its own rules, must either increase taxes or come up with tax cuts elsewhere to cover the cost of tax incentives given to a flexible compensation plan. It is our understanding of these rules that potential productivity gains can not be used to offset these costs. Congress has been generally reluctant to increases in taxes, and would certainly be reluctant to do so for a program with a direct benefit to so few workers. It seems like the choice would be which other programs to cut.

From an economic policy perspective there are additional problems with cash profit-sharing. During good economic periods more money would be distributed as cash. This would be an economic stimulus exactly when the nation does not need one, and is likely to

cause inflation – too much money chasing too few goods. The cash, because it is more than one normally expects as wages or salary, will move through the economy like windfall gains and be very discretionary income. It will heighten the upside of the economic cycle. The converse is also true in economic downturns. Just when it is important to provide an economic stimulus, income to profit-sharing workers would decrease. In short cash profit-sharing on a national scale has a serious economic cyclical aspect because it accentuates the business cycle. It would thus make it much more difficult for Congress and the Administration to control inflation and provide employment when necessary.

Various forms of flexible compensation have characteristics that differ from simple profit sharing plans. For example, the garden variety gain-sharing plans, like a Scanlon plan are linked to factors in the workplace that workers can control individually or as a group. Team concepts are a part of the basic plan and the pay out is directly related to performance and paid in short time periods so that the linkage between performance and pay is fairly close. These plans were built around productivity Improvement, but a few new multiple factor plans build in quality, energy conservation and some even a small element of profit-sharing. But, there is no clear demonstrable evidence that productivity is higher under such plans than under hourly wage plans.

The direct wage incentive plans – piece work, standard hour plans and group direct incentives – are all based on how much time it takes to produce a unit of product. They

are not used as much today as they were. In the 1950's about a third of the manufacturing work force was in direct group incentives. But, machines have taken over much of the work reducing an employee's direct ability to influence production. These systems stressed units produced, relegating quality to a reject allowance. Today quality must be a given in products and quickly built defective products are bad business. Thus, there are fewer workers on direct wage incentives.

Good evidence of the need for union representation when performance based pay plans are used is the fact that agreements with these establishments usually had 2/3 of their grievances related to production standards. Most of the time the employer attempted to increase the standard to cut earnings, but a fair number resulted from workers insisting on making a better product than the employer would allow them to make.

Another major issue was and is worker safety. We have found that workers tend to take more risks when on incentive, most particularly when rates have been reduced and they are trying to maintain their former level of take home pay.

Commission sales are another form of flexible compensation that have their place, but it is not for all establishments. Like profit-sharing these plans also have counter cyclical economic characteristics. That is when economic conditions are good sales and commissions increase and when they are poor they decrease. Congress often hears requests from the real estate industry asking for relief during slow economic times, just when

money for other needs is short.. Direct commissions also have some of the characteristics of direct incentives in that they are individually based and stress the production of sales. Thus, service and other aspects of customer satisfaction are under controlled. Auto sales are a classic example of this point, but one can also recall the legal problems Sears had with commission sales representations.

Another old flexible compensation plan is the merit pay system. This is a system that is usually rejected when workers have a voice through collective bargaining. The concept of paying one person more than another based on supervisory judgement is as old as working for pay. What is new is the systemized approach of doing so. However, doing a systematic merit pay system well is costly. The actual compensation costs are one thing, but the administrative cost is quite another. The design of the plan and communication of the plan is expensive and is often beyond the reach of most small and medium sized firms. Administrative staff time is also quite high, and tends to get cutback when firms are under pressure. As a result the motivating events of performance evaluation meetings and pay increases are relatively infrequent - usually no more than once or twice per year. Also, the firm normally budgets about the same amount of money for merit pay year after year. As a result the beneficiaries often seem to be the same group of individuals and the ability to motivate those at the bottom is lost. Generally the better paid get more for the right reasons, but sometimes it happens for the wrong reasons, like friendships and other bias. Those who get less also sometimes get less for the wrong reasons -- like race, sex, age,

disability, religion or politics. After a few years the system is much less a motivator then it was at the outset.

Employee Stock Ownership Plans (ESOPs), like profit-sharing plans, have the reward far removed form the work place action, and the stock value can be influenced by factors the worker had nothing to do with. Additionally, like profit-sharing there are a lot of workers in public and nonprofit employment who can not participate in these plans. Nevertheless, there are some real differences that tip the scales in favor of ESOP's. The stock is held in an account for the worker so the counter cyclical economic aspects of cash profit-sharing do not apply. The worker has a property right in the stock in his/her account and can vote the stock to influence management decisions, thus the worker has a voice.. When the enterprise has a large share of the equity owned by workers, in union settings, they generally have a representative on the board of directors, enhancing the voice aspect of these plans. However, the most important element of these union plans is that the ESOP legitimizes the workplace committees that do in fact produce productivity gains and quality improvements.

There are modest tax incentives for ESOPs which are just enough to make worker buy-out transactions possible.. They essentially allow the lending bank a fifty percent tax deduction for the interest they earn which allows them to assume some greater risk and lend at a discounted rate to the employee buy-out. Also the enterprise is able to take a tax deduction for payments on both the interest and the principle. Since many of these

enterprises are on the edge of failure this is enough to create the necessary cash flow to get them back on the road to profitability.

Because, pay for performance plans are so complex and work best when tailored to a particular work place and work force the AFL-CIO believes that their design is best left to the parties closest to the situation. A government policy encouraging one type over another is likely to do more harm than good. The best approach is labor and management working together in designing a pay system that fits the situation, with each worker having a voice through a grievance system instead of the door, and a fair base wage before a performance based pay system is added on.

Anderson Graduate School of Management
U.C.L.A.
Los Angeles, California 90024-1481 USA

office (310) 825-1504
secretary (310) 825-2505
office fax (310) 206-2002
home (310) 829-1246
home fax (310) 829-1042
Internet dmitchel@agsm.ucla.edu

June 27, 1994

Mr. Christopher Weare
U.S. House of Representatives
Committee on Small Business
Subcommittee on Regulation, Business
Opportunities, and Technology
B-363 Rayburn House Office Building
Washington, DC 20515-6318

Dear Mr. Weare:

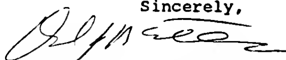
I am enclosing my written statement for the Subcommittee hearing scheduled for 10 AM, Friday, July 15. In the statement, I have tried to respond to the various questions posed in the letter of June 16 from Congressman Wyden. At the hearing, I will make a brief opening statement in accordance with the instructions in the June 16 letter. I will also bring along 75 copies of the written statement as requested.

Please acknowledge receipt of this material. You can leave a message for me at the phone/fax numbers above.

Finally, I might note that I will be traveling with my eleven year old son on July 15. I assume that it will be all right for him to sit in the hearing room.

Thank you for the invitation to testify; I look forward to meeting you on the 15th.

Sincerely,



Daniel J.B. Mitchell
Professor

encl.

Profit Sharing and Gain Sharing for Improved Job Security and Macroeconomic Performance

Daniel J.B. Mitchell
Professor
Anderson Graduate School of Management
U.C.L.A.
Los Angeles, California 90024-1481
Phone: 310-825-1504
Fax: 310-829-1042

July 15, 1994

Written testimony for a hearing of the House Committee on Small Business, Subcommittee on Regulation, Business Opportunities, and Technology, Representative Ron Wyden, Chairman.*

---

* An earlier version of these remarks was delivered at the 68th Annual Western Economic Association Conference, panel on "Policy Implications of Research on Employee Ownership and Profit Sharing," June 21, 1993, Lake Tahoe, California. Panel organizer: Michael A. Conte.

Highlights

•Profit Sharing and Gain Sharing should be encouraged because of their potential macroeconomic benefits in stabilizing and possibly expanding employment. However, the alleged favorable impacts of such plans on productivity to do not provide a rationale for subsidization, since market incentives are already present for micro productivity effects.

•Favorable tax treatment should be provided only to plans which provide explicit formulas linking pay to profit, revenue, or some other value measure, and which put a significant fraction of pay at risk, say 10-30%.

•Favorable tax treatment should not be conditioned on paying bonuses into a deferred retirement fund.

•Employee Stock Ownership Plans (ESOPs) do not in general provide the kind of macro benefits worthy of public subsidy. Tax expenditures now attributable to ESOPs and to discretionary (non-formula) profit sharing should be redirected toward genuine profit and gain sharing plans.

•There is a limited case for government provision of information concerning alternative pay plans, provided it is done in a neutral and accurate fashion. However, there is a substantial amount of private information already available. The issue is quality rather than quantity of information.

•Basic consistent government data on the incidence of profit sharing, gain sharing, and ESOPs are currently limited and could be much improved. More detailed information on the total tax expenditures currently in effect for deferred profit sharing and ESOPs is also needed. At present, much of tax loss is blended into a general category covering all retirement plans.

•The Dunlop Commission neglected pay systems in its recent interim report on worker-management relations. The report includes only limited discussion of ESOPs. Profit sharing and gain sharing encouragement should be major topics in the Commission's final recommendations. More generally, public officials should encourage widespread and significant use of true profit and gain sharing because of the potential macroeconomic and job security benefits.

81-534 O - 94 - 7

Outline

I. Plan Usage

II. The Market Failure Rationale for Intervention

III. The Merit Good Rationale for Intervention

IV. The Social Transformation Rationale for Intervention

V. Applying the Three Justifications to Profit Sharing, Gain Sharing, and ESOPs

- i. Incentive Problems and Evidence
- ii. Productivity is Not Grounds for Intervention
- iii. Information Spreading Policies
- iv. The Merit Good Rationale
- v. The Social Transformation Rationale

VI. An Alternative Macro Rationale

- i. The Macro Case for Profit and Gain Sharing
- ii. Lack of a Macro Case for ESOPs
- iii. Empirical Evidence

VII. How Much Are We Subsidizing ESOPs?

VIII. Conclusions

Tables

Footnotes

Should public policy encourage certain types of pay systems? In particular, should it encourage profit sharing and certain types of gain sharing plans? Are Employee Stock Ownership Plans (ESOPs) and other forms of "pay for performance" as equally deserving of public policy encouragement as are profit sharing and gain sharing.[1] These are the questions I will address.

Although the issue of whether such pay systems are "effective" or "ineffective" in raising productivity or cutting employer costs is important from the usual micro-level managerial viewpoint, I will argue that it is not especially important from a public policy perspective. The kinds of potential public policy encouragement I will consider are 1) subsidies (usually via the tax code), 2) information spreading, and 3) exhortation by public officials and official bodies. And, for these types of policies, it is probably best at this point to state my biases up front. Pay systems which do not have macroeconomic benefits, but simply are said to raise productivity or lower costs, have no special claim on the public purse for subsidies and only a marginal claim for information spreading or other encouragement.

This position is particularly important with regard to ESOPs. Whenever ESOPs are discussed, the worker ownership aspect has had an alluring effect on certain policy makers and social reformers. On the policy making side, former Senator (and chair of the Senate Finance Committee) Russell Long of Louisiana for many years viewed ESOPs as part of a new socio-economic order.[2] Social reformers - in particular the late Louis Kelso - had similar visions.[3]

The result of this approach has been a history of (unjustified in my view) special tax subsidies to ESOPs unavailable to other pay systems and which could have better been directed to appropriate forms of profit sharing and gain sharing. Financiers, managers, and professional compensation consultants took the tax subsidies that resulted from this attempt at social uplift through ESOPs and drew ESOPs into takeover battles, the retention of control of closely-held family enterprises, the obtaining of cheap loans, and tax avoidance. But in a time of federal budget deficits and pressures for fiscal economy, Congressional beneficence towards ESOPs has been eroding, as well it should.

In the past, especially in the 19th century, some reformers - and business owners - saw profit sharing as a way of educating workers on the benefits of capitalism and as a way of solving the "labor problem" of labor-management conflict. Gain sharing has also been seen from time to time as a route to smooth labor relations. But generally, today, it is possible to discuss profit sharing and gain sharing calmly from the personnel management perspective as ordinary employee incentive plans or - from the economist's perspective and more relevant to the matter of public subsidy - as employ<u>er</u> incentive plans.

Although I argue that profit sharing and gain sharing are more deserving of subsidy than ESOPs or other pay systems, I do

not have in mind all plans that today are commonly grouped under the profit sharing or gain sharing labels. Many profit sharing plans in fact do not vary pay systematically with profits or vary too small a portion of pay to matter. To qualify for a tax subsidy, profit sharing plans need to contain a written formula linked to profits and need to put a substantial fraction of pay, say 10-30% or more, "at risk." This percentage is notably higher than typical American practice.[4] On the other hand, the payment of profit sharing bonuses into a deferred retirement-type fund should not be a criterion for tax subsidy. Gain sharing plans also should systematically relate pay to a value-oriented measure (such as plant-level profits, revenue, or value added) to receive a subsidy. And again, a significant fraction of pay should be at risk. On the other hand, gain sharing plans that are essentially group piece rates are not appropriate candidates for subsidy (nor are ordinary, individual piece rates).

When public policy matters are discussed, the issue - at least as posed by economists - is often one of alternatives. Are there better uses for the money than the specific purpose being proposed? In the abstract, posing the issue that way is attractive. In practice, however, such discussions can easily turn sterile. One could in principle compare proposals to favor a certain pay system with <u>all</u> other potential uses of government monies. It could be asked, for example, whether it would be better to spend government resources on space stations, medical research, crime prevention, or tax cuts. But making such comparisons is very difficult because of the wide range of potential uses. Hence, I will not attempt to frame the entire federal budget. I will simply argue that the existing tax subsidy to certain forms of compensation could be better targeted to improve job security and perhaps expand employment.

I. Plan Usage

Before starting discussion of the job security question, it is worth exploring how widespread is the use of various types of pay plans. Table 1 provides available data on profit sharing and ESOPs from the U.S. Bureau of Labor Statistics (BLS). As can be seen at a glance, neither type of plan is widely in use. Especially to ESOP proponents, who have probably seen much more encompassing numbers from other sources, the table may be surprising. (More on the numbers will be presented below). Profit sharing is more commonly used than ESOPs, according to Table 1. But even those numbers are somewhat exaggerated by the tendency of employers to describe as "profit sharing" plans without specific formulas linking bonuses to profits.[5]

For gain sharing, the estimates are even cruder, since the BLS has not included such plans in its regular surveys. The type of gain sharing plans often cited in textbooks - Scanlon, Rucker, and Improshare - were found to be very rare in a General Accounting Office (GAO) study in the early 1980s.[6] A more recent study, not based on a scientific sample and probably upward

biased by a significant margin for that reason, suggested that 9% of employers had some form of gain sharing. However, about two thirds of the plans were not of the strict Scanlon, Rucker, or Improshare types; rather they were customized plans introduced by the employer.[7]

II. The Market Failure Rationale for Intervention

For economists, the main rationales for government intervention in markets are externalities, positive or negative.[8] In either case, the full impact of the behavior of economic actors is neither captured nor felt by those actors. If the externalities of an activity are positive, the actors do not do enough of it (since they receive none of the external benefit). And if the externalities are negative, the actors do too much (since they bear none of the external cost). In short, there is a market failure which public policies (subsidies, taxes, regulations) might be used to correct.

For example, localities may subsidize the siting of new plants in their territory because such siting raises land values of neighbors and creates enhanced employment opportunities for immobile local residents. "Public goods", ranging from provision of national defense to operation of judicial systems and to construction and maintenance of lighthouses are also commonly-cited examples of positive externalities. Similarly, government authorities restrict excessive fishing, oil drilling, and pollution, because of the external negative effects associated with these activities. All of these externality-based examples of government intervention are usually justified on the grounds that private incentives do not impel actors in the economic system to do the right thing.

Most of the externality examples cited in the economics literature are microeconomic. Yet, the big market failures are often macroeconomic in nature. Hence, pay systems that have the potential to alleviate macro failures deserve external encouragement by public policy. It is in everyone's joint interest to avoid recessions and depressions, but no individual can capture the gains of acting in ways which contribute to such alleviation. Often, in fact, individual incentives are to act in ways which aggravate business cycles.

Consider some behaviors that intensify economic downturns. In a typical recession, layoffs begin to occur, thus making consumers nervous and cautious. It would be imprudent, from the individual perspective, to commit to big ticket consumption spending, or other deferrable spending, when job loss is possible. But if consumers cut back on spending, the recession's momentum is accelerated. As spending falls off, the need to invest in new capacity is reduced. Declining investment demand also intensifies the recession. A downward vicious cycle hurting everyone is engendered by individuals acting rationally, because no one has an incentive to consider the small but cumulative

effects of their behavior on the macro economy.

Employers, consumers, and investors are trapped by their own actions. If only the job insecurity effect could be reduced, the vicious cycle could be broken. Appropriate forms of profit sharing and gain sharing plans can break the cycle - in ways I will describe - but there is no market incentive for employers to install these plans for that reason. It will make little difference from the macro perspective whether any particular employer installs a plan and - conversely - all employers will benefit from a more stable economy whether or not they choose to implement profit sharing or gain sharing. Such a situation presents a classic economic case for subsidy.

III. The Merit Good Rationale for Intervention

Less easy to fit into economic reasoning, but still a common target of public policy, are merit goods such as education, health care, vehicles of saving for retirement, provision for the emergencies of life, cultural events, and housing. The justification here tends to be paternalistic and, hence, does not easily accord with simple economic notions of rational individual behavior. Basically, proponents of subsidizing merit goods assume that left to their own devices, people will be too short sighted and will not consume enough of them. Or, perhaps, consumers just don't understand the beneficial effects and can't see how much they would benefit from more education, health insurance, opera houses, home ownership, and zoos than the free market would otherwise provide.

Because profit sharing and ESOPs are often linked to retirement saving - a favored form of merit good - the subsidy of such plans in the past has been linked to their pension-like aspects. As will be noted below, however, profit sharing and ESOPs are not worthier than other kinds of retirement plans for tax subsidy on the merit good rationale. Indeed, in the case of ESOPs in particular, a case can be made that conventional retirement plans are more worthy.

IV. The Social Transformation Rationale for Intervention

Social transformation is sometimes a justification for public policy. The tilts in public policy toward collective bargaining in American labor law of the 1930s and towards civil rights in the laws of the 1960s fall into this category. It may be possible to dress up the social transformation motive in the guise of an externality or a merit good. For example, one might argue that encouraging home ownership gives the owners a "stake" in their communities, creates good citizenship, etc. But often there is a pressing social dilemma or conflict which leads to such shifts in public policy as in the labor-management confrontations of the 1930s and the confrontations over civil rights and race relations in the 1960s.

Engaging in social transformation through pay plans is a matter of taste. Frankly, I am skeptical that fiddling with pay systems amounts to great social transformation. Certainly ESOPs, which have been seen by some as socially transforming, are in my mind overrated. The statistics on plan usage already cited suggest that no revolution has yet occurred. Nor is one likely to occur.

V. Applying the Three Justifications to Profit Sharing, Gain Sharing, and ESOPs

Both profit sharing plans and ESOPs have traditionally been viewed by personnel managers as <u>incentive</u> systems. Proponents argue that they will raise productivity - thus addressing the what economists call the "principal/agent problem" of how to ensure that employees (the agents) do what their bosses (the principals) want in the face of imperfect information and high monitoring costs. Alternatively, such pay plans can be seen as saving on those monitoring costs, i.e., supervisory expense. If workers are led by the pay system to do what their bosses want automatically, then monitors are not needed.

i. Incentive Problems and Evidence

There are many qualifications that real world personnel managers (and economists) would want to make to the traditional view. While both profit sharing plans and ESOPs will make workers better off if the company prospers, the reward from extra effort that goes to the individual worker will be small, especially if the firm is large. In an enterprise of 100 workers, each worker will receive only 1/100 of the added reward; with 1000 workers, the fraction drops to 1/1000. This lack of incentive is sometimes termed the "1-over-N" problem by economists. Note that six out of 10 private-sector workers are employed at firms with 100 or more employees; 45% are employed in establishments of that size.[9] For that reason, some managers seeking incentive pay arrangements for their workers prefer individual incentives such as piece rates and commissions.[10]

But individual incentives have various problems which also are well known. They may favor quantity over quality, lead to wastage of materials as workers strive to meet production targets, and encourage competition when teamwork is desirable. There may be attempts to restrict output in order to beat time and motion estimates of normal work standards. And, although individual pay systems seem to create a common interest in more output between worker and owner, in fact - since workers cannot be given 100% of the value of their work - a gap can open between worker desire to expend effort and employer desire to receive it.[11]

Over the years, pay plans have been developed which attempt to address various aspects of these problems. Group incentive

programs, including gain sharing plans, may be used to foster teamwork, although the free rider problem of sharing the reward can still arise. Some programs, such as Scanlon Plans, use participative arrangements to encourage team spirit as a response to tendencies toward free riders. An overlay of participation in decision making can also be added to profit sharing, ESOPs, or other programs. Or other motivational techniques can be used to encourage team spirit.

So the impact of pay systems comes down to - as economists like to put it - an empirical matter. Since there are pros and cons in the abstract of any pay system, what does the empirical evidence say? As is always the case in economic research, the evidence is inconclusive. But on balance, profit sharing seems to have a positive impact on productivity. ESOPs, although the evidence is weaker, may also have a positive effect. And certainly there are case studies of particular applications of profit sharing or ESOPs which suggest favorable productivity outcomes.[12]

The difficulties in evaluating the evidence or conducting research are well known. Employers which use particular pay plans may be those for which the plans are especially suited; what works for them may not be appropriate for others. That is, evidence of a positive correlation between use of a plan and firm performance may not be definitive as a guide for the average employer or personnel manager.

Companies with good economic performance may choose to share some of the benefits via profit sharing or stock ownership with their employees. In such cases, the causation runs from profits to pay plan installation, not the other way around. While in principle it is possible in statistical studies to control for such problems, in practice the results obtained can be very sensitive to model specification and technique.[13]

So rather than debate the strength of the evidence on productivity, let us concede the case to those who take the positive point of view and simply assume that profit sharing, gain sharing, and ESOPs have salutary effects on productivity. But let us also note that many personnel practices may also have positive productivity or cost saving effects. These include <u>nonfinancial</u> participation schemes (quality circles, autonomous work teams, suggestion boxes), piece rates, ordinary performance appraisal and reward systems, bonuses for good attendance records, use of promotion opportunities as a performance reward, employee assistance plans, and even Muzak in the workplace.[14] A turn-of-the-century telephone company gave its operators free nutritious lunches so that indigestion would not erode their afternoon work performance.[15] The free lunch paid for itself, according to the company, contrary to Milton Friedman's oft-quoted dictum that no free lunch exists!

If there are grounds for subsidizing profit sharing and ESOPs based on supposed positive productivity or cost saving

effects, all other personnel practices which might have the same type of effect are potential targets for fiscal largesse, even free lunches and Muzak. But does anyone seriously propose subsidizing all personnel practices which are purported to enhance productivity or induce cost savings? There are good reasons for not subsidizing Muzak and the multitude of other employer policies that might otherwise have a claim on government largesse.

ii. Productivity is Not Grounds for Intervention

The problem with tax subsidies to all potentially worthwhile personnel practices is that there is no obvious externality stemming from their use. If productivity is indeed enhanced, or if costs are in fact reduced, the employer captures the gain. There is already present all the subsidy needed for these arrangements, but it comes from the normal market incentives facing profit-maximizing employers. What is the case for going further with public resources? There really is no case.

Undoubtedly, creative minds can uncover a market failure or two that needs addressing here. For example, it might be argued that the use of ESOPs as takeover defenses in the 1980s discouraged takeover artists who, in turn, were responding to some improper incentives in the market for corporate control. Of course, some might argue in reverse that ESOP-based takeover defenses entrenched incumbent managers and shielded them from the market. But even if we were to grant the market failure argument in the case of takeover battles, what about alternatives? Might the problem be better addressed through tightly focused antitrust policies than through the blunt instrument of tax expenditures on all ESOPs. The one area of market failure where there are no handy alternatives is at the macro level, an issue to which I have already made reference and which I will take up later.

iii. Information Spreading Policies

It should be clear that the usual rationales for installing profit sharing and ESOPs cited by personnel managers - productivity boosts or cost savings - do not justify tax incentives or other direct subsidies. But there may be some case for limited government expenditure on information spreading. A firm which discovers a pay system that has beneficial internal effects may not have adequate incentives to let that information be known to other employers. (Indeed, there might be incentives to hide it from potential competitors.) So there might be a rationale for government sponsored research, case reports, pamphlets, and conferences to exchange information, along the lines of the activities during the 1980s of the now-defunct Bureau of Labor-Management Relations and Cooperative Programs in the U.S. Department of Labor. The Department's new Office of the American Workplace presumably can resume these functions.

It should be noted, however, that there are clearly some market incentives for private information spreading. Surely, there is no shortage of management consultants who, for a fee, will provide advice on installing particular pay programs. Urban hotel meeting rooms are filled daily with seminars on various personnel problems and purported solutions, including those linked to alternative pay policies. Companies which discover good practices may want to publicize their innovations for public relations purposes. Academics have strong incentives to uncover innovations and information, write papers about them, and thereby receive tenure, merit increases, consulting opportunities, and other glory.

As a indication of the availability of information, I made a quick search using the Nexis database system. Nexis covers newspapers, magazines, trade journals, and similar sources from the U.S. and other countries. Table 2 shows the results. Using the "ALLNWS" (all news) file and the "MAJPAP" (major newspaper) file for years 1991-1993, I searched under the key words "productivity", "employee" and various words descriptive of incentive plans. There was no lack of references regarding both profit sharing and ESOPs. Relatively few references - but still a respectable number - appeared for piece rates and commercially-marketed gain sharing plans such as Scanlon, Rucker, and Improshare. But the number of articles found would have undoubtedly increased if more years were added to the search or if a search had been done of professional personnel journals. Raw informatior, it appears, is readily available now on pay systems.

The argument for government dissemination of pay system information must be, therefore, that the incentives for "reliable" information spreading are insufficient and that, because government is "neutral," its reports and conferences will be seen as more credible (better) than those of potentially-biased private disseminators. Neutral, credible information on pay systems might be viewed as a public good and on that rationale there is some case for subsidizing its spread. At any rate, information spreading about pay plans is likely to cost much less than a direct subsidy to them.

If, however, the case for information sharing is to be made mainly on reliability and quality grounds, the information to be spread at public expense must be accurate. Puff pieces, faddism, and other ills that often characterize private writings about any workplace innovations (including pay systems) must be avoided. Follow-up studies need to be provided. Otherwise, the public sector would simply add to the already-sufficient quantity of materials.

Hyatt Clark - a General Motors parts plant saved from closing by a worker buyout - was the darling of employee ownership until it went bankrupt in the mid 1980s.[16] Seymour Wire was highlighted in a U.S. Department of Labor study - another saved-from-closing plant which eventually went

bankrupt.[17] Even Weirton Steel, cited as a success story in numerous articles and which has not gone bankrupt, has nonetheless laid off some of its worker owners. Moreover, the employee stake in Weirton has been falling as it is forced to go to the outside equity market for capital and will soon be down to 51%.[18] And what are we to make of strike action against a worker-owned shipyard?[19] So if there is to be a public provision of information, the good, the bad, and the ugly must be exposed.[20] Depiction of ESOPs, profit sharing, or other pay programs as panaceas for all management problems should be avoided. The truth is that sometimes they work and sometimes they don't.

One area in which provision of public information is essential is basic data collection. It is very difficult for a private organization to replicate the kind of data gathering undertaken by agencies such as the U.S. Bureau of Labor Statistics. Although there are numerous private surveys of personnel practices including pay, information on their sampling and methodology is often absent. Frequently, surveys by management consulting firms are simply based on their clients and pay little attention to statistical sampling issues. And, in any case, access to the information contained in these surveys by outsiders and researchers may be expensive or nonexistent.[21]

The problem is particularly acute with regard to ESOPs. The National Center for Employee Ownership (NCEO) data series on the number of employees covered by ESOPs is often cited. Indeed, it is reprinted by the U.S. Bureau of the Census in the widely-used Statistical Abstract of the United States.[22] According to this series, there were 11.3 million workers under ESOPs in 1991, although NCEO reports a slight drop to 11 million in 1993.[23] The problem is that this estimate does not square with the BLS figure already seen on Table 1 of 3% of full-time workers in medium to large establishments covered by such plans (and a still lower percentage if we consider part-timers and small firms).[24]

NCEO acknowledges the discrepancy but indicates that its figures include workers under non-ESOP programs which hold company stock, such as stock bonus plans and profit sharing plans.[25] The Center points to another internal U.S. Department of Labor study estimating the number of ESOP participants at 7.1 million in 1990.[26] But still another Labor Department survey suggests the number of workers covered by ESOPs peaked in 1985 and had fallen to 5.3 million by 1988.[27] At best these estimates are inconsistent. Generally, those who want to make the case for an impending revolution of employee ownership like to cite large numbers of covered workers and thus are prone to include non-ESOP plans, even pension plans which hold some company stock.[28] However, it is important that users be aware that non-ESOPs are often lumped with ESOPs in tabulations. The fact that the Bureau of the Census reprints data from NCEO without so much as a clarifying footnote in the Statistical Abstract points to the danger that public information can be just as incomplete as private.

Even when making the case for public data gathering and spreading, it is important to note that pay practices are not the only personnel policies worthy of such attention. There has been a general lack of public surveys of nonunion practices; public data mainly give general employment counts, average pay levels, and rates of pay change. The union sector before the 1980s had better coverage, because of the availability of union contracts as a database. However, federal budget pressures in the 1980s, and the shrinkage of the union sector, substantially eroded that coverage. In short, reports on personnel practices (both pay and non-pay policies) can legitimately compete for public dollars to be spent in the labor market area on information gathering or spreading. This is true whether the information is pure data, case studies, or information gathered from experiments or commissioned research.

iv. The Merit Good Rationale

Congress seems to have decided that saving for retirement is a Good Thing - a merit good - that should be encouraged. Thus, pension programs of various types have received favored tax treatment. Current payments to pension funds by employers are not taxable to the employee until withdrawn upon retirement. And, of course, there is direct involvement of Congress in provision of retirement income through creation of the Social Security system. Are there related merit good aspects of the two types of pay systems considered here - profit sharing plans and ESOPs?

If Congress is hoping to promote "adequate" retirement incomes (and perhaps less dependence on public Social Security), then programs which have a strong element of risk are not the kind of merit goods for which Congress ought to be looking. ESOPs, which tie retirement income to the fate of a single company, violate good portfolio management. For example, a large drop in the value of shares in an ESOP retirement plan became a major issue in recent union organizing drives at a meatpacking plant and a shipyard.[29] Deferred profit sharing plans may or may not be especially risky, depending on what portfolio policies are followed. Of course, cash profit sharing and gain sharing have no direct retirement aspect at all and receive no tax subsidy. Nor, <u>if</u> the analysis is confined solely to the merit good rationale, should they be subsidized. (But I remind the reader that in my view there is a better, macroeconomic rationale which does justify a tax subsidy for non-deferred plans.)

If retirement savings arrangements are to be considered merit goods, Congress needs to consider the risk issue more carefully than it has. Defined benefit and defined contribution pensions receive equivalent tax treatment although they entail different burdens of risk on employer and employee. 401k and 403b plans may or may not permit diversified portfolios, but all of them receive the same tax treatment despite their structural differences. Congress could save some money by targeting its tax

subsidy for retirement plans to those which follow risk-reducing portfolio strategies or - at a minimum - which leave it to the employee to select among a broad range of investment strategies.

Even if portfolio risk is not to be an element in retirement plan subsidies, there is at least a case for simply having all deferred plans - deferred profit sharing, ESOPs, 401ks, 403bs, IRAs, defined contribution pensions, and defined benefit pensions - receive the same favored tax treatment. There is certainly no case, based on the merit good approach, for providing special tax benefits to particularly risky deferred pay systems beyond those advantages applying to any other deferred plan.

v. The Social Transformation Rationale

As already noted, there is a history of regarding both employee ownership and profit sharing as instruments of social transformation. The difference is primarily one of historical timing. Profit sharing plans are rarely today viewed in utopian terms. But ESOPs sometimes are still so seen.

The divergence in the visions surrounding the two types of plans is evident in their tax treatment. Deferred profit sharing enjoys no special tax favors other than those applying generally to all deferred compensation arrangements. Cash profit sharing and gain sharing enjoy no tax favors at all. ESOPs, however, thanks to the efforts of Senator Russell Long, have a history of receiving special treatment beyond the other deferred plans.

Long was acting in the tradition of his populist father, Huey Long, whose "share the wealth" movement in the 1930s attracted a considerable following. Russell Long was impressed with the social transformation through ESOPs proposed by Louis Kelso. When Kelso died recently, his eulogies included the claim that he had made millions of workers shareholders.[30] But in fact, sharing the wealth with workers - even if it taken to mean share ownership rather than other forms of wealth - has come about much more through ordinary pension plans than through ESOPs. Noninsured private pensions held $1,130 billion in equities in 1992.[31] Surely, what Drucker once called "pension fund socialism" is much more impressive as a wealth spreader than Kelso's ESOPs.[32] And with ordinary pensions the equity wealth is diversified across many firms. Where is it written that the wealth to be shared with you as an employee can only be that of the firm in which you are employed?

If we use the BLS estimates of ESOP coverage, i.e., something less than 3% of the private workforce, perhaps what is remarkable is how resistant business has been toward wealth spreading, not how effective the tax favored treatment of ESOPs have been in sharing the wealth. Even the higher estimates of ESOP coverage from other sources leave this observation unaltered. In fact, it was only when the government offered tax credits (not just deductions) to PAYSOPs, a special variant of

ESOPs created by Russell Long, that coverage really spread. Even so, coverage via PAYSOPs peaked at 28% of full-time workers in medium to large establishments, despite the fact that the government was basically buying the shares for the employees.[33]

The record with ESOPs and PAYSOPs shows that government can share the wealth through such plans if it willing to put a very heavy subsidy into the effort. But apparently the subsidy has to be so large so as to be impractical. The observation, already noted, that deferred profit sharing, which has not benefitted from the attention of a Senator Long, seems to be more widely in use than are ESOPs is important. It is our best indication that employers are more receptive to profit sharing than ESOPs (although a sufficient tax incentive can be used to distort their choice).

VI. An Alternative Macro Rationale

Is there another argument for public support of particular types of pay systems that fits standard economic rationale? We have already noted that the externalities approach essentially involves market failures. But productivity enhancements and cost savings are not externalities, since employers internalize them. As also previously noted, there is a kind of market failure that tends to dwarf the microeconomic externality inefficiencies that economists like to cite. The really big failures occur at the macro level and take the form of idle resources, i.e., cyclically-based unemployment and unused capacity. Idle resources are likely to represent much larger costs to society than misallocated resources.

As is often said in macro circles - at least among economists not prone to see unemployment as voluntary leisure and the business cycle as costless - it takes a load of Harberger triangles to fill an Okun gap.[34] A rough estimate is that each 1% increase in the unemployment rate represents a $120 billion loss of GDP.[35] So if encouraging a particular pay system could reduce the sustainable level of unemployment, or even keep the unemployment rate closer to the minimum sustainable level, it would have an externality truly worth of subsidy.

Sadly, there has been little advance in the practice of macroeconomic policy and seemingly little interest in improving it in the past three decades. The ability to fine tune the economy or achieve "soft landings" has proven to be limited. External events such as oil price shocks seem capable of provoking recessions. Fiscal policy is largely paralyzed by large federal deficits. Monetary policy is compromised by changes in financial institutions which make indicators such as the money supply ambiguous. There is uncertainty about whether a 6% unemployment rate is potentially inflationary or whether the number has fallen to 5% because of changes in labor-market institutions.[36] Changes introduced in 1994 in BLS statistical methodology for gathering unemployment data have added to the

uncertainty; 6% or 5% unemployment rates no longer mean what they did before 1994.

In 1964, thirty years ago, Alan Greenspan - then a business consultant - complained about Federal Reserve policy. "In all likelihood," he said, "the Fed will delay any tightening, allowing major imbalances - mainly financial - to develop. Then when it does act, it could touch off a major break in stock prices, which could lead to a recession."[37] Do his views, statements, or actions in 1994 as Fed chairman, suggest that much progress has been made in setting monetary policy? If anything, there is less certainty about the right policy today than there was three decades ago. So - to be consistent with his long-held views - Mr. Greenspan still errs on the side of monetary tightening.

Given this environment, job insecurity is clearly a matter about which the public is much concerned. Seemingly secure jobs are now found to be at risk.[38] Perceived poor macro performance was the downfall of President Bush in 1992. Yet even before the new insecurities in the job market, presidential elections were affected by the business cycle. President Carter in 1980 and candidate Nixon in 1960 were also defeated by poor macro performance. And the fate of President Hoover in 1932 hardly needs mentioning. Surely over six decades of "it's the economy, stupid" in political life should be a signal to policy makers that it is time to try something new and innovative in the field of macroeconomics. Encouragement of the right kinds of pay systems is the only innovation on the table.

i. The Macro Case for Profit and Gain Sharing

There is a long history of viewing profit sharing (and certain types of gain sharing) as a form of back door pay flexibility capable of producing macro benefits. Suggestions along these lines go back at least to the 1930s in the U.S. But much of the discussion in modern economic circles of this effect stems from the work of Martin Weitzman.[39] In the Weitzman model, the firm pays a base wage and a profit sharing or gain sharing bonus.[40] The expected bonus substitutes for some of the time-based (or piece-rate) compensation that would otherwise have to be paid. As a result, the marginal cost of hiring labor is reduced and more labor is hired. A share economy, in the Weitzman model, has a propensity to operate in a perpetual labor shortage. Thus, during periods of demand decline, firms lay off unfilled vacancies rather than real people. The economy is therefore stabilized and tends to stay at full employment. Alternating bouts of inflation and unemployment are avoided.

At one time, such unemployment/inflation problems were viewed as purely the province of monetary and fiscal policy (perhaps mixed with wage-price guidelines or controls). But, as already noted, beginning in the 1970s, many factors have combined to make the (already-complex) conduct of monetary and fiscal

policy more difficult. Apart from the influences previously cited, these factors include the move to flexible exchange rates, the sensitivity of international capital flows to domestic economic conditions, and the end of regulated interest rates on bank deposits. So a micro-level change in pay practices of the Weitzman type, which assisted in the conduct of traditional macro policy, would be especially desirable.

There has been much discussion in economic circles over whether - if complications are added to the Weitzman model - the predicted perpetual labor shortage result would follow. If, for example, firms pay an "efficiency wage" and need an unemployment "penalty" threat for disciplinary purposes, the Weitzman labor shortage might not develop.[41] Such arguments, however, simply illustrate a more general proposition: The more complicated a model becomes, the more ambiguous are its predictions likely to be. And there are strong market incentives for academic economists to add complications to existing models (the aforementioned tenure and glory being among them). But even if the perpetual shortage element is lost from the Weitzman approach, the potential stabilizing effect remains.[42]

Ultimately, a firm's weekly labor costs can be expressed as the product of three components:

$$W \times H \times E$$

where W is compensation (including all elements of pay) per hour, H is average weekly hours, and E is the number of employees. Fluctuations in the demand for labor can be absorbed in all three elements. The standard American firm permits some variation in H, e.g., increasing or decreasing overtime hours, very little variation in W, and takes most of the adjustment in E (via layoffs and hires).[43] Profit sharing, by adding a flexible bonus element to W which is likely to vary with labor demand, permits less stress on E in exchange for more variability in W. This potential stabilizing effect of profit sharing provides the only strong case for subsidizing use of a particular pay system, through the tax system or otherwise. Micro-level employers do not capture the widespread macro-level gains of a more stable economy. They need added incentive to install pay systems that stabilize or we won't have enough such systems.

The benefits are potentially important. As a first approximation, a firm which would otherwise reduce its payroll by 10% through layoffs - a potential disaster for the unlucky 10% (especially if a more general recession was also drying up new job opportunities) - could instead cut the bonus by 10% of total pay. The cost saving is the same. But the pain is spread out more generally across the firm's workforce and, while unpleasant, does not rise to the level of a disaster. In principal, the firm could, without any profit or gain sharing plan, simply vary the basic wage more than is typical and vary employment less. For example, a recent construction industry collective bargaining contract ties wages to market share.[44] However, psychological research shows that explicit plans with "bonuses" make pay

variation more acceptable to employees.[45]

With pay variation through a profit or gain sharing bonus, job security can be provided; the firm can continue to use its full workforce (perhaps for maintenance or training). Note that with greater job security, consumer confidence of the firm's employees is maintained. The overall impact on the economy of greater confidence and security among a single firm's workers is negligible. But if most employees are under such arrangements, the downturn need not rise to the level of a full-fledged recession.

Two qualifications should be noted. First, a macro case for a tax subsidy (or any subsidy) to profit sharing should apply equally to cash, as well as deferred profit sharing (and to certain cash gain sharing plans). At present, only deferred profit sharing receives favored tax treatment and that treatment is no better than for other deferred pay plans. Second, the macro rationale applies only to genuine profit and gain sharing plans, i.e., to those in which the bonus is truly linked to profits through an explicit formula, and should be limited to plans which put a significant portion of pay at risk, perhaps 10-30%. As already noted, this range is above typical U.S. practice. Deferred saving plans, with no formula tying bonuses to profits, are dubious targets for subsidy. If special tax incentives beyond those currently available were offered to any plan simply called profit sharing, vast relabeling without substance would occur.

This last point needs further emphasis. It is not necessarily the case that all plans which lack explicit formulas actually provide bonuses unrelated to profit. Indeed, Kruse finds evidence that such plans are linked to profits on a de facto basis.[46] The problem is that there must be an explicit formula for tax audit purposes, if special tax treatment is to be provided. The IRS cannot bestow tax favors based on vague promises.

ii. Lack of a Macro Case for ESOPs

What about ESOPs? Unfortunately, when pay flexibility is discussed as a policy matter, there is a tendency to throw in all forms of pay which go beyond time-based wages and salaries. And there is confusion between the internally-captured productivity and cost saving effects and the externally-beneficial macro stabilization (and maybe employment-expanding) effects. So ESOPs and profit sharing are viewed erroneously as part of the same story.[47]

As noted earlier, some forms of pay systems may combine ESOP and profit sharing elements, i.e., the profit sharing bonus might be paid in stock placed in an ESOP. In that case, we are really talking about a profit sharing plan and whatever public subsidies apply to profit sharing should apply to the hybrid plan. But a

pure ESOP is quite different. Essentially, it involves a one-time bonus to employees in the form of shares, to which they receive an entitlement. Thereafter, pay is no more flexible than it was before.

There is no obvious reason why the traditional firm balance in the demand management of its labor cost formula - W x H x E - would shift in the face of an ESOP entitlement. If W was inflexible before the ESOP, it is likely to be equally inflexible after. So there is no reason to expect either macro stabilization or employment expansion from more widespread use of ESOPs. Indeed, in the case of worker-owned firms, there has long been concern that incentives to hire would be reduced, as incumbent worker/owners feared their shares of the enterprise's surplus would be diluted by additional claimants.[48] There is no general macro case for a public subsidy of the use of ESOPs.

In certain limited instances where ESOPs are used to prevent plant shutdowns, there might be a rationale on a case-by-case basis for some kind of subsidy. It might be argued that the ESOP facilitated a needed wage concession to the enterprise, lowering labor costs to a competitive level. Possibly workers would not have made such concessions to a standard capitalist firm because they could not be sure that the bargain - lower wages for employment security - would be upheld by the employer.

If there were enough such examples around, ESOPs might add some marginal wage flexibility over the business cycle and help stabilize employment. But case-by-case evaluations are difficult to make, and not the kind of thing I would want to charge the Internal Revenue Service with carrying out. Such matters are not well treated by blunt instruments such as across-the-board tax favors. In any event, the vast majority of ESOPs are not of the plant-saving variety. So it would be expensive to subsidize all ESOPs to capture the benefits of a few.

Sadly, the recent "Dunlop Commission" report, devotes little space to compensation arrangements and to the extent it does pay attention to them, the focus is on ESOPs, not profit or gain sharing.[49] The report is heavily oriented to the union sector where both on empirical and theoretical grounds, profit sharing should be of special interest and a matter of concern for public policy.[50] As is well known, the private-sector unionization rate has declined to about one eighth of wage and salary workers. Many economists believe that inappropriate wage bargains, especially in the 1970s, contributed to the sharp union membership declines of the 1980s.

Had union-sector pay been more closely linked to economic circumstances, as through profit sharing, at least some of the decline might have been avoided.[51] ESOPs will not do the job. I have long argued that labor law might reinforce tax incentives to profit and gain sharing.[52] Since the Dunlop Commission will be recommending specific labor law changes in a second report, it ought to consider how profit and gain sharing can be encouraged.

The Commission certainly should not limit its interests to ESOPs.

iii. Empirical Evidence

As I have previously noted, when theoretical issues are debated to an impasse, economists are fond of declaring that "it's an empirical issue," as if significant debates over policy are often settled empirically. Readers seeking an illustration of the inconclusiveness of empirical argument would do well to review the vast literature on whether minimum wages cause employment displacement. And in the matter of the minimum wage, the only "theory" involved is a downward-sloping demand curve. If we cannot settle that issue empirically, what hope is there for convincingly and definitively demonstrating (or refuting) the macro effects of particular pay systems?

Generally, on the macro side, there is some evidence for Weitzman-type employment stabilization associated with profit sharing.[53] The Japanese case - with large bonus payments which seem to have a profit sharing element - is often cited in regards to both employment expansion and stabilization; Japan has exhibited low unemployment which varies narrowly in response to the business cycle, OPEC oil shocks, and the like.[54] Skeptics, however, will not be convinced by the evidence to date on Japan or on the U.S.

The Japanese case can always be set aside as somehow culture-bound and not relevant to Americans. And it is difficult to obtain evidence concerning how the U.S. economy would work with widespread, genuine profit and gain sharing since these plans have never been widespread. Evidence based on those American firms with some form of profit sharing plans today (many of which are not genuinely based on profits and/or do not put significant portions of pay at risk) is unlikely to be conclusive.

There has not been much research on the macro effects of ESOPs, perhaps because no one expects macro effects from them. Possibly there should be such investigations; who (in academia at any rate) can be against more research?[55] But absent a convincing economic model predicting beneficial macro effects from ESOPs, what would we make of a finding that there nevertheless were some?

Hypothetically, we might find evidence that a variety of personnel practices, some unrelated to pay, seemed to be linked to employment stabilization. Suppose - for example - it turned out that the use of job evaluation was associated statistically with such an employment-stabilizing effect.[56] I doubt that anyone would propose subsidizing job evaluation on macroeconomic grounds, based on such a finding. More likely, there would be a rounding up of the usual suspects to prove that the correlation was spurious. And it would be right to do so. In some cases, you simply have to go with theory. Unless there is a plausible

theory under which ESOPs have positive macro consequences, empirical evidence that suggested they do cannot be persuasive.

VII. How Much Are We Subsidizing ESOPs?

As already noted, both profit sharing and ESOPs receive the general favored tax treatment applicable to all deferred pay plans. Given the apparent merit good rationale that Congress applies to saving, there is not much to quibble over here. But since ESOPs have no special claim beyond the deferred treatment, it is important to determine what added subsidy they do receive. Unfortunately, determining the amount is not a straight-forward matter.

In fiscal year 1994, the tax loss officially attributed specially to ESOPs is $2 billion.[57] This is not a great deal of money when placed against a $6½ trillion GDP or even a $1.2 trillion level of federal receipts. Included in that estimate is the tax loss due to favorable treatment of loans to ESOPs, a provision which has been restricted in coverage as part of the general post-Russell Long retreat from tax subsidies to these plans.[58] And, of course, the incredible PAYSOP subsidy of the mid 1980s is long gone (no pun intended!).[59]

However, within the official estimate for the fiscal year 1994 federal tax loss was the tax deductibility of principal repayment in leveraged ESOPs. Although Kelso thought this was a great tax advantage, if ESOPs are honestly valuing the stock given to employees, it is not at all clear that any real subsidy is involved. The principle repayment mirrors the supposed value of the stock given to employees. If the valuation is genuine, there is no reason why the cost should not be deductible, just as cash wages given to employees (or Thanksgiving turkeys given to employees) are also deductible.

For companies with publicly-traded shares, valuation is not a major issue. But for closely-held companies, which are often attracted to ESOPs, the possibility of deliberate overvaluation looms. Such overvaluation has the potential for cheating the IRS (and the employee), and there is some indication that it has occurred.[60] Indeed, the seeming rush to create ESOPs when the tax code was first changed in the mid 1970s to allow the principal deduction is itself suspicious; the rush suggests there may be losses due to tax evasion.

Profit sharing plans, unlike ESOPs, seem less likely to pose problems of tax evasion. There is no stock to be valued. And if there were a requirement that a formula link bonuses to profits, those profits can be audited, just as profits are now audited for corporate income tax purposes.

A start could be made, however, by channeling the indirect tax expenditures for ESOPs to genuine profit sharing (cash and deferred) and by setting forth tight standards for existing

profit sharing plans to obtain any tax-favored treatment. The problem is that the $2 billion in tax expenditures attributed to ESOPs does not include the more general pension-type treatment of ESOPs. These tax losses for ESOPs are buried in the $48.8 billion attributed to employer retirement plans (pensions, 401ks, etc.) in fiscal 1994. Also buried in that large sum are tax losses for deferred profit sharing plans with no explicit profit-linked formulas. It is extremely difficult to estimate how much of the $48.8 billion could be redirected toward true profit sharing and gain sharing plans. Perhaps another $1-3 billion might be available. Surely, it would be worth asking the Office of Management and Budget (OMB) to make a reasonable estimate.

Former Senator Everett Dirksen is reported to have said about the federal budget: "A billion here, a billion there, and soon you're talking about real money." Although the magnitudes available for subsidy may not seem large, they are real money; taking them away from plans not worthy of subsidy would essentially terminate new contributions to those plans. Employers would look for alternative plans which would meet the tax code requirements. If genuine profit and gain sharing were available for equivalent tax-favored treatment, I would expect much of the money now going into ESOPs and discretionary deferred profit sharing would quickly be redirected to the tax-favored plans. Exhortation and publicity by public officials and groups such as the Dunlop Commission could speed the process and make true profit and gain sharing the norm in American employment practices.

VIII. Conclusions

There are three possible rationales for subsidizing pay systems such as profit sharing and ESOPs. The traditional economic approach requires positive externalities (market failure). Even definitive proof that particular plans raise productivity or lower employer costs would not qualify for subsidy under this approach since such benefits are internalized by the firm. Normal market incentives are sufficient. Only features that improve macro performance, e.g., Weitzman-style employment expansion or stabilization, benefits not captured by the firm, are candidates for subsidy. And it is profit sharing plans (and certain associated gain sharing plans) which are likely to have these macro externalities, not ESOPs.

The economic approach is somewhat less definitive when it comes to information gathering and dissemination (as opposed to direct subsidy). Possibly, firms do not have adequate incentives to spread information about their internal pay innovations. Certainly, it is difficult for private information gatherers to replicate the kinds of data surveys undertaken by BLS. So there is always a case for using some public resources to study both ESOPs and profit sharing.

Certain public subsidies are granted on the grounds that consumption of a particular merit good is inherently desirable.

It appears that Congress thinks saving for retirement falls into this category, and provides a general subsidy towards it through the tax system. There is some case to be made on the merit good rationale for providing such treatment to deferred profit sharing and ESOPs, if it is to be given to other pensions and saving plans. However, ESOPs at closely-held firms provide an opportunity to cheat the tax collector due to the stock valuation problem. And, in any case, ordinary pensions - because they do not concentrate portfolios in the stock of a single firm - are superior to ESOPs, even accepting the merit good approach.

Social transformation is sometimes viewed as grounds for the intervention of public policy. Profit sharing is no longer viewed as a mechanism for social transformation. But ESOPs, because of the worker ownership aspect, still are seen that way by some observers. Ultimately, social transformation is a matter of taste. Claims, however, that ESOPs are well on the road to accomplishing a redistribution of wealth and a change in the social order are substantially overstated. It is surprising how few workers - not how many - are covered by genuine ESOP plans. In any case, pensions have created far more indirect share ownership by workers than ESOPs have (or ever will).

And a final word: The Dunlop Commission has so far neglected alternative pay systems other than ESOPs in its studies of worker-management relations. Before it makes final recommendations about changes in labor law and public policy, it ought to focus on true profit sharing and gain sharing and develop strategies for fostering these more socially-worthy approaches. More generally, public officials should be encouraging profit and gain sharing in speeches and forums wherever possible.

Table 1

Deferred Profit Sharing and Employee Stock Ownership Plans

	Deferred Profit Sharing			Employee Stock Ownership Plans		
	Medium & Large Establishments 1991		Small Establishments (a) 1990	Medium & Large Establishments 1991		Small Establishments (b) 1990
	Full-Time	Part-Time	Full-Time	Full-Time	Part-Time	Full-Time
All Employees	16%	10%	15%	3%	*	1%
Professional/ technical	13	-	16	4	-	1
Clerical/ Sales	16	-	17	4	-	1
Production/ Service	18	-	13	2	-	*

*Less than 0.5%.
- = not available.

(a) When confined to small independent businesses (as opposed to establishments), the data in this column are 14, 15, 16, 13.

(b) When confined to small independent businesses (as opposed to establishments), the data in this column are 1, 2, *, *.

Source: U.S. Bureau of Labor Statistics, press release USDL 92-764, December 9, 1992; U.S. Bureau of Labor Statistics, Employee Benefits in Small Private Establishments, 1990, bulletin 2388 (Washington: GPO, 1991), pp. 79, 85.

Table 2

Results of Nexis Search for Articles on Pay Systems

(Number of Articles Found)

Key Words Used	MAJPAP File	ALLNWS File
"Profit sharing"	130	857
"ESOP" and/or employee stock ownership"	38	348
"Piece rate"	5	119
"Gainsharing and/or "gain sharing"	56	386
"Scanlon Plan" and/or "Rucker Plan" and/or "Improshare"	0	32
"Pay for performance"	28	208

Note: The search was made on June 23, 1994 Nexis automatically includes certain variations of words and phrases such as plurals. For example, a search of "piece rate" will capture articles on "piece rates". All searches also required the presence of the words "productivity" and "employee" and were confined to 1991-1993.

Footnotes

1. Sometimes different types of plans, especially profit sharing and ESOPs, can be combined. But for conceptual reasons, we discuss them separately in what follows. One study reports that there are about 2,000 companies with profit sharing plans at least half invested in company stock. Source: "ESOPs Decline in 1992: Other Plans Grow," Employee Ownership Report, vol. 13 (May/June 1993), p. 1.

2. For those interested in Long and his background, see Robert Mann, Legacy to Power: Senator Russell Long of Louisiana (New York: Paragon House, 1992).

3. Louis O. Kelso and Mortimer Adler, The Capitalist Manifesto (New York: Random House, 1958).

4. Bonuses in Japan, which some argue are de facto profit sharing (see below) average about 20% of total compensation and about 25% of cash payments received by production workers in manufacturing firms. Source: U.S. Bureau of Labor Statistics, Handbook of Labor Statistics, bulletin 2340 (Washington: GPO, 1989), p. 574. The Profit Sharing Council of American used to conduct a survey which provided data on profit sharing payments as percent of pay. In the late 1980s, figures of about 9% were typical. Unfortunately, later surveys do not provide this information. See Profit Sharing Council of America, 1990 Profit Sharing Survey (1989 Experience) (Chicago: PSCA, 1990), p. 5. U.S. Chamber of Commerce data suggest even lower proportions for deferred profit sharing, around 3%. However, cash bonuses from profit and gain sharing plans are not broken out. See U.S. Chamber of Commerce, 1993 Edition, Employee Benefits: Survey Data from Benefit Year 1992 (Washington: Chamber of Commerce, 1993), p. 26.

5. Three-fifths of the participants under deferred profit sharing plans in medium-to-large private enterprises had their bonuses determined by a profit-related formula in 1989. The rest were under plans in which the bonus was determined at employer discretion. Source: U.S. Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms, 1989, bulletin 2363 (Washington: GPO, 1990), p. 110.

6. U.S. General Accounting Office, Productivity Sharing Programs: Can They Contribute to Productivity Improvement?, AFMD-81-22 (Washington: GAO, 1981). I include mention of Improshare here because it is often included with other gain sharing plans. However, unlike Scanlon and Rucker plans, Improshare plans are essentially group piece rates based on physical output rather than a value measure. As such, Improshare does not have the desirable job security and macroeconomic advantages of value-based gain sharing and profit sharing plans which are described below. For more on Improshare, see Roger T. Kaufman, "The Effects of Improshare on Productivity," Industrial and Labor Relations Review, vol. 45 (January 1992), pp. 311-322.

7. The authors included ESOPs and profit sharing along with Scanlon, Rucker, Improshare, and customized plans. I have adjusted the figures to remove ESOPs and profit sharing plans. See Steven E. Markham, K. Dow Scott, and Beverly L. Little, "National Gainsharing Study: The Importance of Industry Differences," *Compensation and Benefits Review*, vol. 24 (March 1992), pp. 34-45.

8. Many of these points are made in Douglas L. Kruse, *Profit Sharing: Does It Make a Difference?* (Kalamazoo, Mich.: Upjohn Institute, 1993), especially chapter 5.

9. U.S. Commission on the Future of Worker-Management Relations, *Fact Finding Report, May 1994* (Washington: GPO, 1994), p. 8.

10. Daniel J.B. Mitchell and Renae F. Broderick, "Flexible Pay Systems in the American Context: History, Policy, Research, and Implications" in David Lewin, Donna Sockell, and David Lipsky, eds., *Advances in Industrial and Labor Relations*, volume 5 (Greenwich, Conn.: JAI Press, 1991), pp. 95-149, especially pp. 130-136.

11. Daniel J.B. Mitchell, David Lewin, and Edward E. Lawler III, "Alternative Pay Systems, Firm Performance, and Productivity" in Alan S. Blinder, ed., *Paying for Productivity: A Look at the Evidence* (Washington: Brookings Institution, 1990), pp. 15-88, especially pp. 48-51.

12. General reviews of a variety of pay systems can be found in Blinder, *op. cit*. and a special issue on "Do Compensation Policies Matter?" of the *Industrial and Labor Relations Review*, vol. 43 (February 1990). A comparison of evidence on profit sharing and ESOPs can be found in Douglas L. Kruse, *Economic Journal*, vol. 102 (January 1992), pp. 24-36.

13. Seongsu Kim, "Does American Profit Sharing Increase Firm Profits?, paper presented at the Boston meetings of the Industrial Relations Research Association, January 3, 1994.

14. Readers might not be surprised to know that the Muzak Company - which now terms its service "environmental music" - can cite studies showing productivity boosts. Its music becomes more lively at certain hours of the day when it is believed that worker productivity is likely otherwise to slacken. It is interesting to speculate on why academics do not do much research on background music's effects on productivity and certainly do not call for tax subsidies for it. I would guess that the notion of almost subliminally stimulating productivity is less politically correct than techniques which seem to be "participative" or "sharing." Sources: "Bank Employees are Proof Environmental Music Works," *Modern Office Technology*, vol. 32 (September 1987), p. 26; Mark Trumbull, "Muzak Pipes in Data, Advertising as Well as Tunes," *Christian Science Monitor*, December 29, 1992, p. 7.

15. Elizabeth Lewis Otey, *Employers' Welfare Work*, U.S. Bureau of Labor Statistics bulletin 123 (Washington: GPO, 1913), pp. 61-62.

16. Hyatt-Clark was treated as a success story in the normally skeptical, union-oriented Labor Research Review. See "The Hyatt-Clark ESOP: An Interview with Jim May," Labor Research Review, number 5 (Chicago: Midwest Center for Labor Research, 1985), pp. 25-33.

17. Michael Remez, "Union Leader Has Hopes for Failed Business," Hartford Courant (August 10, 1992), business weekly, p. 3; U.S. Department of Labor, Bureau of Labor-Management Relations and Cooperative Programs, "Saving Jobs and Putting Democracy to Work: Labor-Management Cooperation at Seymour Specialty Wire," labor-management cooperation brief no. 11, September 1987.

18. Maria Mallory, "How Can We Be Laid Off If We Own the Company?," Business Week (September 9, 1991), p. 66; "A Firm of Their Own," Economist (June 11, 1994), p. 60.

19. National Steel & Shipbuilding has been employee-owned since 1989 but a strike was called in late 1992 by the employee/owners over a pay increase demand after a long wage freeze. The company's management threatened to replace strikers permanently in the course of the dispute. A temporary cooling off period ended the strike and provided a small pay increase. Source: Chris Kraul, "Strike Called at West's Last Big Shipyard," Los Angeles Times, October 2, 1992, p. A3; and later news reports.

20. One of the few articles to trace through an unhappy ESOP experience is Tove H. Hammer and Robert N. Stern, "A Yo-Yo Model of Cooperation: Union Participation in Management at Rath Packing Company," Industrial and Labor Relations Review, vol. 39 (April 1986), pp. 337-349.

21. Sanford M. Jacoby and Daniel J.B. Mitchell, "Alternative Sources of Labor Market Data" in Barbara D. Dennis, ed., Proceedings of the 38th Annual Meeting, December 28-30, 1985, Industrial Relations Research Association (Madison, Wisc.: IRRA, 1986), pp. 42-29.

22. U.S. Bureau of the Census, Statistical Abstract of the United States: 1993 (Washington: GPO, 1993), p. 543.

23. "Employee Ownership Plan Numbers Steady for 1993," Employee Ownership Report, vol. 14 (May/June 1994), p. 1. NCEO reports that because of data difficulties, it will no longer make annual estimates.

24. There were 86.1 million private wage and salary earners in 1990. Three percent - clearly an upper-limit estimate of ESOP coverage since part-time coverage is lower than that - would be 2.6 million workers.

25. "More on the Number of ESOPs," Employee Ownership Report, vol. 13 (May/June 1993), p. 10.

26. "Employee Ownership Plan Numbers Steady for 1993," op. cit., p. 1.

27. Michael A. Conte and Helen H. Lawrence, "Trends in ESOPs" in John A. Turner and Daniel J. Beller, eds., Trends in Pensions 1992, Pension and Welfare Benefits Administration, U.S. Department of Labor (Washington: GPO, 1992), p. 146. I have omitted workers remaining under tax-credit ESOPs which ceased to receive their heavy tax subsidy in 1986.

28. For example, see the database used in Joseph Raphael Blasi and Douglas Lynn Kruse, The New Owners: The Mass Emergence of Employee Ownership in Public Companies and What It Means to American Business (Champaign, Ill.: HarperBusiness, 1991), pp. 8-28. Blasi and Kruse come up with an estimate of 10.8 million workers covered by "employee ownership plans" in 1989. Their figure is based partly on estimates from the National Center for Employee Ownership and includes pensions, 401k plans, and profit sharing plans which hold employer stock, stock options, etc.

29. "Challenged Ballots to Determine Outcome of Election at N.C. Meatpacking Plant," Daily Labor Report, June 9, 1993, pp. A3-A4; Greg Kenefick, "Shipbuilders Contest ESOP Rip-Off," AFL-CIO News, May 30, 1994, p. 5.

30. "Louis Kelso, Employee Stock Ownership Pioneer, Dies," Washington Post, February 22, 1991, p. D5.

31. U.S. Bureau of the Census, Statistical Abstract: 1993, op. cit., p. 526. State and local government pensions held another $464 billion in equities and insured private pensions indirectly held still more. ESOP holdings make up only a small part of these totals. Blasi and Kruse, The New Owners, op. cit., p. 23, for example, put ESOP assets of the top 1000 plans at $47 billion in 1990.

32. Peter F. Drucker, The Unseen Revolution: How Pension Fund Socialism Came to America (New York: Harper & Row, 1976).

33. The tax subsidy to PAYSOPs was estimated to be over 100%. See U.S. Office of Management and Budget, Special Analyses: Budget of the United States Government, Fiscal Year 1987 (Washington: GPO, 1986), pp. G29-G30. The 28% coverage estimate is from U.S. Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms, 1986, bulletin 2281 (Washington: GPO, 1987), p. 81.

34. Harberger triangles (named after Arnold C. Harberger) are measures of microeconomic inefficiency caused by taxes, subsidies, and other such distortions of free-market pricing. They are the usual focus of micro-level discussions of public policy costs. Okun gaps (after the late Arthur M. Okun) are a macro measure of lost output due to business downturns.

35. Simple regression analysis suggests that during the period 1979-1993, a 1 percentage point increase in the unemployment rate was associated with a 2% decline in real GDP. Hence, in 1993, the loss associate with each percentage point of the unemployment rate was about $120 billion.

36. See the testimony of Audrey Freedman before the House Budget Committee, June 8, 1994.

37. "How 50 Leading Economists See 1965", Business Week, March 28, 1964, p. 25.

38. James L. Medoff, "The Mid-Life Job Crisis: Growing Unemployment Due to Permanent Layoff Among Middle-Aged American Men," report series, National Study Center, Washington, D.C., May 12, 1994.

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

40. The bonus might be also be a share of revenue or value added, as under some gain sharing plans or pay plans in the film and TV industry.

41. David Levine, "Efficiency Wages in Weitzman's Share Economy," Industrial Relations, vol. 28 (Fall 1989), pp. 321-334.

42. On the MacNeil-Lehrer NewsHour, June 5, 1992, Weitzman described the Lincoln-Electric Company's profit sharing system as follows: "The mechanism is that the pay adjusts automatically so that a worker is being paid less when times are bad and is automatically being paid more when times are good. So the system is adjusting through pay, rather than through the number of workers employed." Lincoln-Electric - a manufacturer of arc-welding equipment - has long been noted for its use of profit sharing and piece rates and maintains stable employment for its workers. Gain sharing has sometimes also been implemented by companies explicitly to stabilize employment. See the case study of the Scanlon plan at Xaloy, Inc., a firm producing specialized metal piping: Steven E. Markham, K. Dow Scott, and Walter G. Cox, Jr., "The Evolutionary Development of a Scanlon Plan," Compensation and Benefits Review, vol. 24 (March 1992), pp. 50-56.

43. Daniel J.B. Mitchell and Mahmood A. Zaidi, "Macroeconomic Conditions and HRM-IR Policies," Industrial Relations, vol. 29 (Spring 1990), pp. 164-188, especially pp. 171-174.

44. "San Diego Electricians Approve Contract With Increases Tied to Market Share Gain," Daily Labor Report, June 10, 1994, pp. A6-A7.

45. Daniel Kahneman and Richard Thaler, "Economic Analysis and the Psychology of Utility: Applications to Compensation Theory," American Economic Review, vol. 81 (May 1991), pp. 341-346.

BOSTON PUBLIC LIBRARY
3 9999 05705 8628

46. Douglas L. Kruse, "Does Profit Sharing Affect Productivity?, working paper no. 4542, National Bureau of Economic Research, November 1993, p. 25.

47. Thus, when the British government installed special tax incentives for flexible pay systems in the late 1980s, it applied them to profit sharing and ESOPs. Coverage by all such plans has increased in Britain from negligible numbers to 1.2 million workers in 1992. Source: Economist, May 9, 1992, p. 71; April 24, 1993, p. 62.

48. Domenico Mario Nuti, "On Traditional Cooperatives and James Meade's Labor-Capital Discriminating Partnerships" in Derek C. Jones and Jan Svejnar, eds., Advances in the Economic Analysis of Participatory and Labor-Managed Firms, vol. 4 (Greenwich, Conn.: JAI Press, 1992), pp. 1-26. Weitzman's profit sharing plan has been called "taxation without representation" because he assumes that workers will not acquire managerial control under profit sharing and therefore will not acquire the power to restrict hiring. See John P. Bonin, "The Share Economy: Taxation Without Representation" in Derek C. Jones and Jan Svejnar, eds., Advances in the Economic Analysis of Participatory and Labor-Managed Firms, vol. 3 (Greenwich, Conn.: JAI Press, 1988), pp. 185-200.

49. U.S. Commission on the Future of Worker-Management Relations, Fact Finding Report, op. cit., pp. 43-44.

50. Gary W. Florkowski and Kuldeep Shastri, "Stock-Price Response to Profit Sharing in Unionized Settings," Journal of Labor Research, vol. 13 (Fall 1992), pp. 407-420; Daniel J.B. Mitchell, "The Share Economy and Industrial Relations: Implications of the Weitzman Proposal," Industrial Relations, vol. 26 (Winter 1987), pp. 1-17.

51. Daniel J.B. Mitchell, "Three Suggestions for Ensuring a Future for the American Labor Movement," Canada-U.S. Outlook, vol. 3 (May 1993), pp. 5-40.

52. Daniel J.B. Mitchell, "Inflation, Unemployment, and the Wagner Act: A Critical Appraisal," Stanford Law Review, vol. 38 (April 1986), pp. 1065-1095.

53. A review of studies dealing with the stabilizing effect of profit sharing can be found in Douglas Kruse, "Profit Sharing in the 1980s: Disguised Wages or a Fundamentally Different Form of Compensation?" in Randall Eberts and Erica Groshen, eds., Structural Changes in U.S. Labor Markets: Causes and Consequences (Armonk, N.Y.: M.E. Sharpe, 1991), pp. 67-99, especially pp. 79-84.

54. Richard B. Freeman and Martin L. Weitzman, "Bonuses and Employment in Japan," Journal of the Japanese and International Economies, vol. 1 (1987), pp. 168-194; Kazutoshi Koshiro, "Bonus Payments and Wage Flexibility in Japan" in Kazutoshi Koshiro, ed., Employment Security and Labor Market Flexibility: An International Perspective (Detroit: Wayne State Press, 1992), pp. 45-77.

55. See Gary W. Florkowski, "Profit Sharing and Public Policy: Insights for the United States," Industrial Relations, vol. 30 (Winter 1991), pp. 96-115. However, keep in mind Mark Twain's observation in another context that "researchers have already cast much darkness on the subject, and if they continue their investigations we shall soon know nothing at all about it."

56. Job evaluation is a commonly-used technique for setting wage differentials between occupations within a firm. In the most formal approaches, jobs are given point ratings according to various attributes. Money values are then assigned to the points.

57. U.S. Office of Management and Budget, Budget of the United States Government, Fiscal Year 1995, Analytical Perspectives (Washington: GPO, 1994), p. 59.

58. It might be noted that there was an argument that ESOPs provide somewhat less tax incentives than other forms of deferred pay because dividends paid on shares are not tax deductible, unlike interest on loans. In that view, the special treatment given interest payments by ESOPs (the exemption of one half of the proceeds from lender income tax liability) crudely offset the dividend disadvantage. Note that the interest provision has since been restricted. See Myron S. Scholes and Mark A. Wolfson, "Employee Stock Ownership Plans and Corporate Restructuring: Myths and Realities," Financial Management, vol. 19 (Spring 1990), pp. 12-28, especially pp. 24-26.

59. The subsidy cost for PAYSOPs for fiscal 1987 was estimated to be $4 billion. This cost was restrained by the limit on the subsidized employer contribution of 1.5% of payroll. Source: U.S. Office of Management and Budget, Special Analyses, Budget, 1987, op. cit., p. G39.

60. U.S. General Accounting Office, Employee Stock Ownership Plans: Who Benefits Most in Closely Held Companies?, HRD-80-88 (Washington: GAO, 1980).

81-534 (204)

ISBN 0-16-046349-1