

## **Matchmaking: The Influence of Monitoring Environments on the Effectiveness of Variable Pay Systems**

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One account of the increase in pay inequality that has occurred in the UK over the last two decades focuses on the effect of the progressive evolution away from uniform time-based pay systems towards those incorporating elements of variable compensation such as performance-related pay and profit sharing. Theorists of the New Economics of Personnel (NEP) predict that, *ceteris paribus*, these variable pay systems provide micro-incentives for individuals to raise their level of output, and thereby enhance aggregate economic performance. However, they note that such pay schemes are not appropriate in every work context, as the efficacy of variable pay systems is largely determined by management's ability accurately to measure worker effort and business outcomes. Therefore, the structure of the monitoring environment emerges as the key intervening variable in the relationship between pay systems and economic performance. Accordingly, in establishments where monitoring is cheap and accurate, the use of variable pay enhances performance; where the opposite is the case, performance is optimised by use of time-based pay. Thus, NEP theory implies that the match or mismatch between pay system and monitoring environment strongly affects performance outcomes.

Using panel and cross-sectional data from the 1998 UK Workplace Employee Relations Survey, we test this relationship at the workplace level by means of a two-stage process. First, with reference to those aspects of the workplace monitoring environment deemed salient by NEP theory, we predict workplaces in which the use of variable pay is appropriate. By comparing these predictions to reality, we are able to determine the existence of "matched" or "mismatched" combinations of pay system and monitoring environment. Further, we find that cases of match exhibit superior economic performance characteristics to those of mismatch.

In the second stage, we hypothesize that workplaces do not necessarily know everything about their own monitoring environment prior to their decision to introduce a variable pay system. Consequently, they must experiment with alternative pay systems if they are to discover which optimises performance. We therefore expect that in general workplaces that try and retain variable pay systems will be those in which there exists a match between pay system and monitoring environment, and workplaces that reject them will be cases of mismatch. Examining the histories of workplace pay systems in the light of our first-stage predictions on the appropriateness of a workplace's use of variable pay, we find that the evidence supports this hypothesis, although this does not preclude the possibility that some workplaces implement suboptimal combinations. In addition, it indicates the existence of a "diffusion curve"—the result of this iterative process—that describes the growing influence of variable pay systems in the economy.

In conclusion, we find evidence to support the predictions of NEP theory that variable pay systems can lead to enhanced performance. Further, we determine that this relationship is strongly constrained by the nature of a workplace's monitoring environment. The important policy consequence of these findings is that workplaces should only adopt (or retain) variable pay systems if their monitoring environment is appropriate to them. Lastly, given the robust association in our data between variable pay systems and pay inequality, we conclude that the account linking these two phenomena is persuasive.