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Effective Employee Incentive Plans: Features and Implementation Processes

Abstract

[Excerpt] This paper will evaluate the effectiveness of broad-based employee incentives, identifying the features of effective plans. For our purposes, “broad-based” is used to signal that more than 50 percent of employees are eligible for this variable pay plan. In addition, the terms “variable pay plan” and “pay for performance” are used interchangeably as they appeared in the original sources.

Keywords

incentive plans, compensation, pay for performance

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Comments

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CORNELL HR REVIEW

EFFECTIVE EMPLOYEE INCENTIVE PLANS: FEATURES AND IMPLEMENTATION PROCESSES

Allison A. Gordon & Jennifer L. Kaswin

A 2007 *WorldatWork* survey found that 70 percent of compensation professionals believe that incentive pay is “important or very important” to the success of their organization.¹ The economic downturn has accentuated the need to contain compensation costs by holding down fixed-based salary expenses. To maintain competitive pay plans, an increasing number of companies are giving more employees across different job functions the opportunity to earn variable, performance-driven incentives for achieving individual and organizational goals.²

This paper will evaluate the effectiveness of broad-based employee incentives, identifying the features of effective plans. For our purposes, “broad-based” is used to signal that more than 50 percent of employees are eligible for this variable pay plan.³ In addition, the terms “variable pay plan” and “pay for performance” are used interchangeably as they appeared in the original sources.

Effectiveness

Recruitment and Retention Effects

Implementing a pay for performance system has been shown to resolve organizational problems because it aligns the preferences of firms and employees. In addition, creating a pay for performance system serves as a sorting mechanism to identify and attract the most capable employees. This type of system has shown that individual pay incentives significantly improve productivity.⁵

Pay for performance systems have further been proven to have two advantages for organizations: attracting more high-quality employees and motivating employees to exert more effort at their jobs. There is some risk involved with pay for performance systems, and the incentive effects of the system may negatively impact risk-averse employees since they have a fear of failure under this plan.⁴

Productivity Implications

Daniel Pink, author of *Drive: The Surprising Truth about What Motivates Us*, asserts that using “carrots and sticks” to motivate is counterproductive to motivation and productivity. Companies that have switched from salaries to individual incentives have increased productivity dramatically—some by as much as 44 percent. Linking pay to performance not only motivates but also helps to recruit and retain the most talented

employees. New graduates seek to join organizations that make use of performance-related rewards, and they have long-term loyalty to these organizations.⁵ The use of variable pay has also grown in popularity, as 67 percent of companies offer some form of variable compensation to employees below the executive level. Likewise, the practice of compensating managers below the senior executive level with stock options and other forms of long-term incentives has risen dramatically. This is because performance-sensitive pay aligns the interest of all levels of employees with the interests of shareholders.⁶

Features of Effective Plans

Top Management Support

Supervisors must understand the incentive pay process in order to support and administer it. Oftentimes, a lack of understanding causes managers to ignore or adapt the process as they see fit. Moreover, if supervisors are not trained on how to measure performance, the process will not be standardized across the company.⁷

Having buy-in from key stakeholders is crucial for the success of an incentive pay system. For example, if top management does not support such a program, lower-level managers will place little importance on effectively administering the program. Hence, a lack of top management support often leads to a lack of accountability.⁸

Communication

Consistent and methodical communication is necessary when implementing an incentive pay plan. It will ensure employees understand what is expected of them while decreasing the likelihood of morale problems that result from misinterpretations of how incentives are awarded.⁹ Furthermore, one survey found that just 25 percent of respondents communicate to specific employee groups, but of those that did, 74 percent said it was either an effective or very effective strategy.¹⁰ **American Airlines** used effective communication to successfully implement its compensation plans, as discussed later in this report.

Performance Management

Oftentimes, a flawed performance management system is the main reason an incentive pay system is not successful. When designing a performance management process that will be linked with pay, it is imperative that both employees and managers know what the individual goals are, how they will be measured, and how they will be compensated when achieved.

Managers must also be careful to ensure that there is adequate differentiation between high and low performers. If mediocre employees are given an average merit increase, they will perceive that their performance is adequate. Conversely, if excellent performers

only receive a little more in incentive pay than average performers, they will perceive that the company does not value their performance.¹¹

Appropriate Rewards

The amount of incentive a company should offer to an individual depends on current income, amount of effort needed to invest, likelihood of obtaining the reward, acceptance of risk, equity of reward and contribution, and industry standards. A minimum for incentive pay is considered to be 5 to 15 percent of an individual's base pay.¹²

Considerations before Implementing a Plan

The best compensation plans take into account several key considerations. Before instituting a pay for performance system, companies should define which employees should be eligible for the program. Furthermore, it is important for companies to determine the role of equity in a total rewards framework from the perspectives of the employee and employer, as well as in terms of cost. Steps should be taken to (1) review the current objectives and purpose of the equity plan; (2) identify alternative rewards; (3) develop a communication plan for how the effectiveness of the program will be measured; (4) gather employees' perspectives via surveys, focus groups, or internal research; (5) gather external market information; (6) determine the costs; (7) develop recommendations for design change; and (8) create the communication plan. The communication strategy for the program should encompass the value employees place on various rewards and how the changes will be perceived by employees. It should then monitor and manage employees' reactions to the changes in their compensation structure.¹³

Objectives of a Broad-Based Incentive Plan

When creating an incentive plan, the organization has to determine and clearly define the goals for the program. The objectives should be aligned with the business strategy. These goals should be utilized to shape the incentive plan as well as the expectations and objectives of individual employees.¹⁴ A main reason why incentive plans fail is because they are introduced as an inflexible process.¹⁵ The incentive plan should be first implemented on a small group of employees in order to determine the flaws and rectify them before implementing them across the enterprise. Once the plan is implemented, it should be regularly adapted.¹⁶

If companies want a pay for performance system, the firm should define the desired performance and establish methods of measuring it first. Then, connect goals for individuals, for business units, and for the company. Meanwhile, track everyone's progress and periodically give back the data to raise everyone's awareness of the program.¹⁷ Sixty-two percent of compensation professionals report that their organizations did not attempt to measure the return on investment of their compensation program.¹⁸

Degree of Uncertainty

In addition, organizations must consider the degree of uncertainty when implementing a pay for performance plan. When the firm's earnings are highly variable, too much uncertainty associated with the realization of outcome-based incentives can cause employees to reduce effort or take actions designed to reduce the variability of their pay. It is best when organizations have compensation systems that have components of both high base pay and high variable pay.¹⁹

The amount of line of sight employees have influences their motivation and how well they respond to a pay for performance system: the employees who have closer line of sight feel more empowered and view the pay for performance system as fair and equitable.²⁰ Studies have shown that in order to make a pay for performance system most effective, a pay guarantee that pay for performance earnings cannot fall below fixed salary earnings should be put in place. This mitigates the risk associated with a pay for performance system and will ensure that even the most risk-averse employee's performance will not suffer due to the system.²¹

Case Study

American Airlines introduced broad-based variable compensation plans that are designed to allow all employees throughout the company to participate so the entire organization can share in the success. There are two components to the incentive plans—accomplishment of goals related to customer service and financials. American Airlines managers sought input from employees, the unions, and the Board of Directors to create these broad-based variable compensation programs. When employees achieve the customer service goal, they receive a \$50 reward each month. For non-management, support staff, and other lower level employees, awards under the financial component—in combination with the customer service awards—provide total annual plan payouts ranging from 2.5 percent of eligible earnings at threshold, 5 percent of eligible earnings at target, and 10 percent of eligible earnings at maximum.²²

Conclusion

Research indicates that broad-based incentive plans can be utilized as a means to encourage both employee performance and productivity. When implementing an incentive plan, several considerations are needed to ensure the plan is successful. However, it is important to note that incentive plans cannot ensure employee productivity by themselves. They must be coupled with effective human resources practices in order to ensure a successful work environment. These include determining the appropriate rewards, instituting comprehensive performance management systems, widespread and effective communication, as well as buy-in from top management to support the compensation plan.

Over the past decade and increasingly in the past year, variable pay has become the standard as companies reward strong performance and lower overhead costs. This trend is expected to continue in the coming years.²³ ✎

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