

## **An Overview of Recent Trends in Incentive Pay Programs**

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### **ABSTRACT**

*This article examines recent trends and developments in an increasingly popular HR practice--incentive pay programs. In addition to highlighting major developments in recent empirical studies, this article also synthesizes recent research pertaining to general guidelines or strategies for design, implementation, and the utilization of incentive pay programs. Counter arguments pointing out potential pitfalls and precautions will also be discussed. The article concludes by offering some recommendations for future research.*

### **INTRODUCTION**

As competitive pressures mount, organizations are compelled to consider strategies that will help them become more innovative, productive, and efficient. It is essential that organizations maximize all resources to optimize the effectiveness of their operations. While many factors impinge upon this effectiveness, labor is an important resource that often represents a significant portion of expenses incurred by organizations. Considering the need to remain competitive, innovative compensation strategies such as incentive programs are often developed in an attempt to align individual motivation and goals with the objectives of the organization.

Considerable research exists on psychological theories explaining how and why incentive pay motivates performance. Likewise, there is considerable research on typologies of incentive pay. Since the research in these areas is rather mature and quite voluminous a complete review of such research is outside the scope of this article. Research related to incentive programs in unionized organizations will also be avoided since these programs are usually a function of labor negotiations and not a result of the organization's desire to tie compensation to organizational performance.

As stated previously, competitive pressures in the domestic and global market are placing demands on organizations to be more productive and efficient than ever. This competitive pressure is evident in human resource strategies utilized by corporations. To some degree, the risk faced by corporations is now being shared with the workers. Tully (1995) pointed out that employees are sensing an increased level of anxiety, since they might not know from one year to the next whether they will receive compensation increases or even have a job. Tully points out that this collective risk is being operationalized in incentive programs that often impact as much as 30% of a manager's income.

## **PREVALENCE OF INCENTIVE PAY PROGRAMS**

It is apparent that the use of incentive programs is becoming more commonplace. The National Association of Manufacturers surveyed 4,500 companies to follow up on prior studies examining skill level of workers and common human resource practices. They found that 54% of these companies offered some type of bonus plan and another 35% offered some type of gain-sharing or pay for performance program (Micco, 1997).

The use of incentive pay is becoming so pervasive that it has been adopted by some of the most respected industries in our nation. For example, Pagoago and Williams (1993) utilized the Hay Survey to query pay practices of 1,256 hospitals and 350,000 individuals in the healthcare field. They found that over half the responding hospitals utilized some type of incentive plan for staff and that a growing number of these organizations used contingent pay such as discretionary bonuses, skill based pay, and team based pay. It is also interesting to note that survey results indicated a significant decline in the growth rate for base salaries over the last two years suggesting that incentive pay could be replacing more traditional pay practices. Hagland (1997) also points out that changing pressures in the medical field have resulted in compensation for physicians becoming more incentive based. The author implies that incentive pay is proving to be more effective than paying physicians a salary.

The use of incentive pay is also becoming more pervasive for certain departments within organizations. Avery (1997) attributes much of the growth in HR salaries over recent years to the use of incentive pay. He suggests that this also reflects the growing importance of HR in organizations' overall business strategies.

Considerable research also exists supporting the increased use of incentive pay for groups verses individuals. Wilson (1990) points out that firms utilize this strategy in an attempt to increase teamwork and promote flexibility, while also boosting productivity. He refers to a group incentive plan as any variable pay program where compensation is awarded based on the unit or group to which an individual belongs. This could include team- or project-based incentives. It could also include gain-sharing programs. Wilson cautions that corporate profit-sharing plans, individual incentive plans with group measures, and special recognition awards cannot be classified as group incentives. Despite their obvious benefits, the point is also made that group incentives are not for all organizations.

## **RESEARCH REGARDING STRUCTURAL ATTRIBUTES OF INCENTIVE PAY PROGRAMS**

While there is some variance in specific structural recommendations, research is replete with common structural themes for incentive programs. Successful incentive programs are founded on sound HR practices and strategies. As a part of this comprehensive, well-rounded HR program, an incentive program can play a significant role in motivating staff to achieve organizational goals. While there are seemingly infinite types of programs which work, it should be noted that most successful programs seem to exhibit several consistent traits. One important aspect of a successful

incentive program is a well-founded salary program with appropriate base pay. Another trait often associated with successful programs is a communication plan which adequately conveys the structure and purpose of the program (Britton, 1997). This communication plan is part and parcel of the contingency link between business issues critical to success and specific incentives (Anfuso, 1995).

Letourneau (1997) offered several precursors to the implementation of a successful incentive program. These precursors included knowing why the program was being implemented, acknowledging that there would be some degree of individual failure, involving staff in the development of the program, and having a contingency plan available if the incentive plan does not work.

Similarly, Rubino (1995) discussed 10 strategies identified by Ernst & Young for the development of effective incentive pay programs. They suggest that a successful plan should fit the environment, be fair to all employees and the company, set total cash compensation, yield financial rewards to the workers and the company, involve workers and supervisors, use internal and external data, set clear performance goals, and achieve clarity through communication.

It is also worth noting Romano's (1998) description of the American Compensation Association's attempts to develop the "perfect" incentive program. They proposed achieving this through acknowledging quantitative and qualitative indicators of performance, comparing with other organizations, determining specific incentive pay, developing caps, rewarding employees who come close and rewarding everyone equally. The importance of adequate communication of the plan by company executives is also reinforced.

### **A Closer Look at the Methods Used in the Development of Incentive Programs**

Several authors suggest that the process utilized to develop an incentive program is often as important as the specific elements of the program. The importance of the developmental process is highlighted in research documenting actual industry examples. Heneman, Fox and Eskew (1998) provide an overview of the process a company went through to develop an incentive pay program.

Simcom, a ten year old company that manufactures flight simulators, sought to create an innovative incentive program to assist them in motivating workers to perform proportionate to the tremendous growth they were experiencing. Simcom employed a comprehensive three-phase approach in implementing the program. First, they assessed employee readiness and need. Next, they designed a program based on those needs. After implementing the program, management assessed the effectiveness of the program by comparing post implementation results with results prior to implementation.

The program was operationalized by measuring factors considered to be important to customer service. These included understanding company goals, relationships with peers and supervisors, willingness to take risks, creativity, self-improvement and communication. The plan,

administered by a management-employee committee, sets aside 10% of the companies annual operating profit to fund the profit sharing plan which is paid out twice a year. Preliminary results indicated an increase in worker satisfaction with pay and a decrease in supervisor ratings of employee performance (the article touts this as a positive influence since it is perceived that supervisors take appraisals more seriously as a result of the new incentive program).

Other industry examples not only support the importance of the process, but provide interesting insight into innovative methods used to tie incentive programs to organizational goals. Clark (1995), for example, highlights an innovative program implemented at Virginia Power Company. The Power Company developed a team based incentive plan called Success Sharing. The program was designed to support their business strategies of remaining a low cost producer, achieving excellent operations, encouraging continuous improvement and motivating a productive workforce. This is achieved by closely aligning compensation to organizational performance in these key areas.

A case study of a successful program implemented by a New England jewelry manufacturer is offered by Johnson (1996). This organization relied on a cross-functional team with members from all areas of the organization to design a fully functioning program. Their development included defining eligibility, defining measures, developing a reward formula, developing distribution criteria and deciding on the frequency of payment.

### **Research Supporting Potential Benefits of Incentive Pay**

Utilization of incentive programs in American industry has been so effective that it has caught the attention of government. Leonard (1996) reviewed a report from the Committee for Economic Development (CED) noting that a flexible work force and capital market have given the U.S. a distinct competitive advantage in the global market place. Frank Doyle, chairman of CED contends that pushing organizational rewards (profit) further down into the organization through incentive programs is critical to maintaining this flexibility. He also calls for a more liberal use of stock options as a strategy to maintain our nation's competitive position in the global market.

Incentive pay is also of interest to businesses in the service industry. Research supporting the use of incentive pay in service industry is plentiful, particularly in the area of sales and marketing. Patrick Hughes (1997), Vice President of Sales and Marketing for Blue Cross and Blue Shield of Massachusetts suggests that "firms in the service industries and managed care industries that offer aggressive incentive structures create a hunger in the sales organization, whereas those that proved comfortable base salaries foster complacency."

### **Productivity Implications**

Smoot and Duncan (1997) conducted an experiment looking at the impact of three different incentive programs on worker productivity. They found a systematic relationship between the incentive programs and worker productivity in all of their experiments. Further, they found that

these programs elicited higher productivity than flat pay systems in the experiments. The negatively accelerated program was found to have the most profound impact.

### **Beyond Productivity**

There is some indication that companies utilize incentive programs for more than just increasing productivity. Bencivenga (1997) acknowledges the notion among some experts that incentive programs are also being used to offset wage stagnation and to avoid layoffs during profitable periods.

Ichniowski, Shaw, and Prensushi (1997) expanded the examination of the impact of incentive programs on productivity by looking at productivity in conjunction with other innovative work practices including flexible job assignments, employment security and teams. Their first significant finding was that clusters of complementary HR practices had a positive impact on productivity. They concluded the opposite for individual work practices. Further, they found that work practices such as utilization of problem solving teams had more of an impact on productivity when used in conjunction with such practices as training and incentive pay. They suggest that it is important to take a holistic view of an incentive system utilizing complementary HR strategies instead of examining these practices in isolation. This study also highlighted other HR practices having a positive impact on incentive pay. These included recruiting and team meetings, team based structures, objective performance measures, flexible job design and extensive communication protocol.

Research on complementary HR practices is supported by the work of Chen, Sawyers, and Williams (1997). Chen et al.'s study reveals how several companies align their compensation structures to support ethical business practices. Levi Strauss & Co. for example bases one third of an employee's evaluation on aspirational behaviors including value diversity and ethical management. The authors suggest that these strategies enhance quality as well as ethical behavior throughout the organization.

Creating pay programs that truly reward performance is also one of the six complementary HR practices that entrepreneurial firms utilize (Cantoni, 1997). Abandoning use of performance appraisal systems, discontinuing use of published salary grades and ranges, and injecting flexibility into the pay program are also cited.

The idea of creating a culture of ownership seems to be a common theme in recent research related to incentive programs. Bencivenga (1997) suggests that companies are enhancing performance and becoming more profitable by creating internal cultures of ownership. He sees this transition in culture coupled with sharing more information with employees and giving them input into how the company is managed as linchpins to the success of such programs.

Banker, Lee and Potter (1996) set out to examine the impact that contextual factors such as competitive intensity, customer focused strategy and behavior based control had on an outcome based incentive plan focussing on customer service. They found that sales, customer satisfaction

and profits increased as a result of the outcome based incentive program. It is interesting to note that these same measures decreased with the level of supervisory monitoring.

### **Other, More Subtle Advantages of Incentive Pay**

When considering labor costs, organizations often overlook expenses related to turnover. Gerhart and Trevor (1996) conducted a study examining the strategic compensation practices in 152 organizations. They found that the design of compensation programs in these organizations was related to employment variability in two important ways. First, they concluded that there was less employment variability in organizations relying more heavily on long term incentives. They also concluded that employment variability was lower when incentives were extended to teams or groups. They point out the obvious advantages in reducing employment variability such as lower costs associated with costs of layoffs, severance pay, and lower unemployment insurance taxes.

Incentive compensation is often an integral component of HR practices in entrepreneurial firms. Cantoni (1997) suggests that these companies do this to eliminate weak links and to reward top performers who significantly contribute to the viability of an organization. He supports this notion by contending that true pay for performance occurs in highly competitive, low-margin businesses. The rationale for this contention is that the very survival of these businesses is at stake and that they will do whatever it takes to survive.

One study even suggested that incentive programs can improve the quality of decisions made by individuals. A study of 84 subjects by Stone and Ziebart (1995) suggested that performance based incentives led to changes in information processing behavior and improvements in decision making. Information processing was enhanced by closer examination of alternatives, more liberal use of time in making selections and employment of decision-making strategies which lead to more accurate choices.

### **Potential Pitfalls and Precautions**

Some researchers such as Filipczak (1996) are staunchly opposed to using money as a motivator. Filipczak views this as an extrinsic tool with minimal long-term value. Instead, he suggests that organizations which tap into employees' intrinsic motivation are much more likely to have staff who desire to do a good job, produce quality products, and take pride in their work. Further, he suggests that organizations achieve this through giving employees an opportunity to have input into their jobs, respecting employees and allowing them to do a good job.

For an incentive program to meet the objective of contributing to an organization's success, it is critical that it measure and reward the right things. To the extent that this is achieved, pay serves as an important tool for communicating business priorities. Britton (1997) suggests that incentive programs have a negative impact on motivation when they measure the wrong things. Consequences they can result in destruction of long term motivation, handicapped employee relationships, and an aversion to taking risks. Britton views incentive programs as a carrot and stick approach. He supports this contention by offering Kohn's (1993) conclusion that rewards intended

to motivate certain behavior are actually bribes. The surprising argument is made that employees worth retaining do not truly believe that incentive pay and pay for performance motivate them to achieve objectives, especially when it is seen as the sole motivating factor.

Small businesses face unique challenges when considering strategies for linking pay to performance. One important challenge is a specialized management skill associated with the atypical growth patterns of a small business. In smaller, start up organizations there is the potential that individuals will be required to perform multiple tasks. This could result in highly individualized responsibilities and functions. In addition, organizations experiencing extreme growth could be faced with tumultuous changes to keep pace with demand. This lack of standardization and frequent change can make it difficult to adequately define and measure performance/incentive goals (Fuller-Love & Scrapen 1997).

Anfuso (1995) noted that individual incentive programs were losing their popularity, in part, because they do not promote teamwork, quality improvement, and other important business issues. He further suggests that these programs can work against these objectives. Difficulty in measuring individual performance is offered as a significant causal effect of these results.

Other research not only criticizes the structure of programs, but also the purpose of the programs. Incentive programs utilized by businesses in highly regulated industries have been characterized as highly sophisticated, but lacking effectiveness since these organizations are not driven by business necessity (Cantoni, 1997).

### **CONCLUDING THOUGHTS: DIRECTIONS FOR FUTURE RESEARCH**

Oliver (1996) argued that no one could prove incentive pay improved performance. This argument is heavily challenged by overwhelming case studies citing the positive impact these programs have had on organizational performance. Despite the obvious advantages of incentive pay programs, researchers and organizations have failed to show the impact of these programs over extended periods of time. Since the long-term viability of an organization should be the ultimate objective, longitudinal studies examining the impact of incentive programs over time are needed.

In addition, it would be interesting to examine whether gender differences in pay carry over into the realms of incentive pay programs. Fortune (1992) conducted a survey of 200 salespeople working for organizations with incentive pay programs and found that men were twice as likely to be offered incentives as women.

As global competition intensifies, future research should also consider the need for fundamental changes in incentive programs. It is crucial that our incentive programs remain competitive with those offered internationally for two very important reasons. First, U.S. companies will be competing in the product market and price will continue to be an important determinant of consumer choice. Secondly, the labor market will also become more competitive as organizations seek incumbents with proven track records as entrepreneurs.

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