Pay for Performance: Applications
Overview: Individual Incentive Plans

- Offer a promise of pay for some objective, pre-established level of performance

- **Common feature** - An established standard against which employee performance is compared to determine magnitude of incentive pay

(Milkovich & Newman, 2008)
Individual-Based Pay-for-Performance Plans

- Merit Pay
- Lump-Sum Bonuses
- Individual Spot Awards
- Individual Incentive Plans

(Milkovich & Newman, 2008)
Merit Pay

- A merit pay system links increases in base pay to how highly employees are rated on a subjective performance evaluation.

- Issues:
  - Expensive
  - Doesn’t achieve desired goal: Improving employee and corporate performance
  - Can be difficult and time consuming to administer

(Milkovich & Newman, 2008)
Managing Merit Pay

- Improve accuracy of performance ratings
- Allocate enough money to truly reward performance
- Make sure size of merit increase differentiates across performance levels

(Milkovich & Newman, 2008)
Lump-Sum Bonuses

- Increasingly used substitute for merit pay
- Not built into base pay
- Viewed as less of an entitlement than merit pay
- Less expensive than merit pay over the long run
Individual Spot Awards

- Viewed as highly or moderately effective
- Typically awarded for exceptional performance
  - Special projects
  - Exceptional performance

(Milkovich & Newman, 2008)
Advantages of Individualized Incentive Plans

✓ Substantial contribution to:
  • Productivity raise
  • Lower production costs
  • Workers earnings

✓ Reduces direct supervision to maintain reasonable output levels

✓ Enables labor costs to be estimated more accurately than under payment by time

✓ Helps costing and budgetary control

(Milkovich & Newman, 2008)
Disadvantages of Individualized Incentive Plans

- Conflicts may emerge between employees and managers.
- Introduction of new technology may be resisted by employees.
- Reduced willingness of employees to suggest new production methods.
- Increased complaints of poor maintenance, hindering employee efforts to earn larger incentives.

(Milkovich & Newman, 2008)
Disadvantages (cont.)

Increased turnover among new employees discouraged by the unwillingness of experienced workers to cooperate in on-the-job training

Elevated levels of mistrust between workers and management

(Milkovich & Newman, 2008)
Team-Based Systems
Overview of Team Incentives

- Improve organizational performance
- Use organizational measures
- Measured periodically

(Milkovich & Newman, 2008)
Gain-Sharing Plans

Employees earn bonuses tied to unit-wide performance as measured by a predetermined formula

(Milkovich & Newman, 2008)
Key Elements in Designing a Gain-Sharing Plan

- Strength of reinforcement
- Productivity standards
- Sharing the gains
- Scope of the formula
- Perceived fairness of the formula
- Ease of administration
- Production variability

(Milkovich & Newman, 2008)
Profit-Sharing Plans

- Predetermined index of profitability
  - Employees may not feel their jobs directly impact profits

- The trend in recent variable-pay design is to combine the best of gain-sharing and profit-sharing plans
  - The plan must be self funding
    - Along with having the financial incentive, employees feel they have a measure of control

(Milkovich & Newman, 2008)
Earnings-at-Risk Plans

- **Success sharing plan**
  - Employee base pay is constant
    - Variable pay increases in successful years
    - No reduction in base pay and no variable pay in poorly-performing years

- **Risk sharing plan**
  - Employee base pay varies
    - Base pay often reduced in poor performance years
    - Shifts part of risk of doing business from company to employee

(Milkovich & Newman, 2008)
Group Incentive Plans: Examples

- All incentive plans can be described by common features
  
  - The size of the group that participates in the plan
  
  - The standard against which performance is compared
  
  - The payout schedule

(Milkovich & Newman, 2008)
Interest in Long-term Incentive Plans

- Long-term incentives (LTIs) focus on performance beyond the one-year time line used as the cutoff for short-term incentive plans

- Recent growth in long term plans is spurred in part by a desire to motivate longer-term value creation

(Milkovich & Newman, 2008)
Long-Term Incentive Plans

Employee Stock Ownership Plans (ESOPs)

Performance Plans (Performance Share and Performance Unit)

Broad-Based Option Plans (BBOPs)

(Milkovich & Newman, 2008)
Performance Pay Obstacles

- Difficulties in specifying and measuring job performance
- Problems in identifying valued rewards
- Difficulties in linking rewards to job performance

(Milkovich & Newman, 2008)
Conditions for Effective Variable Pay-for-Performance Plans

- Plan clearly communicated
- Plan understood
- Rewards easy to calculate
- Employees participate in administering plan
- Employees believe they are being treated fairly
- Employees believe they can trust company and have security
- Rewards awarded as soon as possible after desired performance

(Milkovich & Newman, 2008)