

BREAKING BOUNDARIES

for Operating Excellence



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The Level of Incentive Pay that Drives Performance

Issue:
155

Background for this BREAKING BOUNDARIES

This **BREAKING BOUNDARIES** article provides hard data, and plainly speaks to the level of incentive pay that positively changes employees' workplace thinking and behavior. It is this sought after employee change that produces rapid, significant, and sustained operating performance improvements as well as improved profitability.



Having launched over 250 High Performance Work Systems (each with an incentive pay component), and conducted hundreds of client site and public workshop on Incentive Pay Systems, I am routinely asked "How much incentive pay does it take to change employee behavior?"

My answer is predicated on the following assumptions:

1. The overall employee relations environment is "okay to good". If the employee relations environment is toxic, almost no reasonable amount of incentive pay will drive employees to improve operating excellence.

2. Leaders are willing to communicate operating performance to all employees on a regular basis in a visual, easy to understand format.
3. The incentive pay system is properly designed. (see article #152 titled "Power of Incentive Pay Systems" ... go to www.bovino-consulting.com and click on the Performance Improvement Articles menu)

Without debate, the answer will differ based on industry pay practices (some industries are, traditionally, highly incentivized while others are not), employees' position in the company, scope of responsibilities, company's pay philosophy, and the classic relationship between base pay and incentive pay in different jobs/professions.



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Survey Results

Extensive and numerous surveys of our client base in manufacturing, mining, and distribution center operations provide a clear picture. During a 4-year period, we surveyed 3,552 employees at all company levels (general managers to gate guards ... white collar to blue collar ... exempt salary to hourly ... new employees to seasoned employees). The findings between companies and industries were very similar.

74% of all employees surveyed stated that they begin to think and behave positively toward performance improvement when they can (with reasonable effort) earn an incentive payout of 5% to 7% of their base pay.

The 1st important take home message is:



Don't waste your time launching an incentive pay system that has an upside payout of 2% to 4% of payroll. The incentive will be ineffective, and leaders will remain frustrated with flat line performance.

War Story:

I received a call from the COO of an electric utility company experiencing difficult financial times. They had recently implemented an 8% base pay reduction for all employees. Predictably, that move was not well received.

The company requested our help designing and implementing an improvement initiative with an incentive pay component. During our first leadership meeting, it was revealed to me that their incentive pay plan must have a cap (or maximum payout) of 2% of pay.

*After two subsequent meetings I failed miserably in convincing senior executives that a cap on an otherwise well designed plan would only serve as a cap on performance ... **never cap an incentive pay plan.** Furthermore, a 2% maximum payout would not be motivational. 2% of pay (especially with a 2% cap) would do nothing to generate excitement and commitment in the workforce on behalf of their betterment initiative. I recommended the company contact other consulting firms ... and they did. Another firm helped design and launch a plan with the 2% cap.*

Fast forward six months ... I received another call from the COO apologizing for their lack of incentive pay knowledge and their unyielding commitment to a bad plan design (the 2% cap). The utility company cancelled their incentive pay system.

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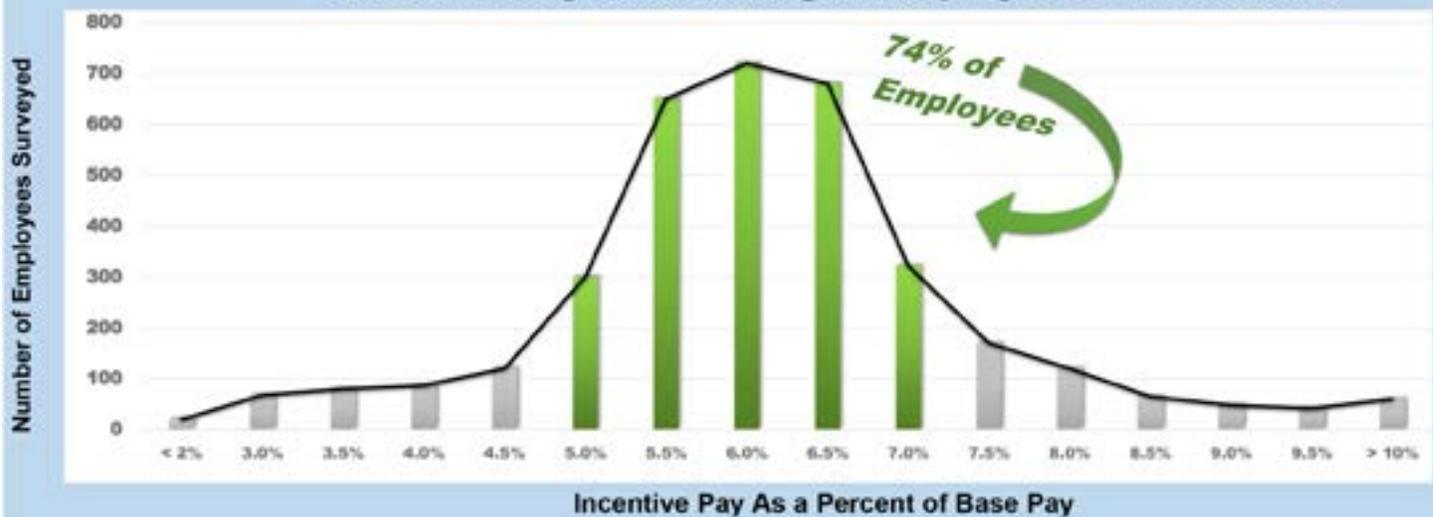
The 2nd important take home message is:



Test (and retest) your incentive pay system to ensure the payouts make business and motivational sense, relative to the improvement. You don't want huge payouts for small improvements, and you don't want anemic payouts for significant improvements. One of our 30 "Classic Fatal Flaws" in the design of an Incentive Pay System is, "Not testing the incentive pay system against various performance improvement assumptions".

During the design of an Incentive Pay System for each KPI, it is critical to test/validate the Incentive Pay System against easy, moderate, and aggressive performance level assumptions. The 'easy to achieve' performance levels should generate an incentive pay fund in the range of 3% to 5% of payroll. The 'moderate to achieve' performance levels should generate an incentive pay fund in the range of 6% to 10% of payroll. The 'difficult to achieve' performance levels should generate an incentive pay fund in the range of 11% to 17% (or more) of payroll.

Incentive Pay That Changes Employee Performance



	Incentive Pay As a Percent of Base Pay																TOTAL
Employees Surveyed	20	68	80	87	120	300	650	720	680	322	170	120	65	48	42	60	3552
Incentive Pay as % of Base Pay	< 2%	3.0%	3.5%	4.0%	4.5%	5.0%	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%	9.5%	> 10%	-
Percentage of Employees	1%	2%	2%	2%	3%	9%	18%	20%	19%	9%	5%	4%	2%	1%	1%	2%	100%

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Beyond the survey data are other experience-based observations. First, the greater the incentive pay earned, the greater the employees' motivation level to strive for greater improvements. Second, based on "feet on the ground" experience, the real powerhouse motivational level for employees kicks in when they earn incentive payouts in the 10% to 18% range.



The Best Sign of Success

Many factors, beyond improved operating performance, help define the success of a High Performance Work System, and the impact of an Incentive Pay System on employee performance. The employee behavior that best signals "the incentive pay system is working" is when better-performing employees begin to nudge, encourage, and (gently and not so gently) remind marginally-performing employees to "pick up the pace", "get out of our way", "stop wasting time" or "don't screw up my bonus".



When these occur, your company just scored a **big win** ... a positive change in employees' workplace thinking and behavior.

Thanks for reading,

Vince Bovino - Principal Consultant