

Variable Pay Plans

OVERVIEW

Variable pay plans are a competitive necessity in the workplace, driving higher performance from low and average performers. They are a current form of compensation that provide not only additional pay for employees, but also play a significant role in an organizational rewards program. Variable pay forms consistently have shown that they are a better way of attracting, retaining, and motivating key talent and removing the burden of increased fixed costs not associated with increased performance. The following study conducted by ERC seeks to explore this variable pay plan phenomenon and the local trends that exist in terms of their design and administration. The study confirmed:

- Sixty-one percent of organizations surveyed have a variable pay plan.
- Individual performance and market rates are the most common criterion for pay progression or increases.
- Profit-related variable pay plans rank high in frequency of usage.
- Low performers generally increase their performance as a result of variable pay plans.
- The most common average percentage of performance pay allocated annually was between 4 and 6 percent.
- Communication is one of the main challenges associated with variable pay.

VARIABLE PAY PLANS

Sixty-one percent of organizations surveyed have variable pay plans and those organizations that do not have a variable pay plan in place do not plan to institute one in the next year. As a general rule, all employees are typically eligible to participate in these plans.

Pay progression is commonly determined by individual performance and market rates. Only a small percentage of organizations continue to use length of service and cost of living criteria to determine increases, suggesting that these historic standards of determining pay progression are no longer the norm for organizations. Above all, employee performance counts.

Exhibit 1: Criterion for Pay Progression or Increases

Criterion for Pay Progression or Increases	
	Percent
Individual Performance	69.6%
Market Rate	60.9%
Organizational Performance	34.8%
Accumulation of Skills	34.8%
Cost of Living	21.7%
Team Performance	13.0%
Length of Service	13.0%

The most common variable pay plans used by organizations are individual-related performance pay and profit-related performance pay. Employee share/ownership pay was the least commonly used variable pay plan. Performance pay based on team performance and skills/competencies tend to be moderately used by organizations.

Exhibit 2: Variable Pay Plans

Variable Pay Plans	
	Percent
Individual-related performance pay	78.6%
Profit related pay	71.4%
Team-based performance pay	35.7%
Skill-competency related performance pay	35.7%
Employee share/ownership pay	7.1%

In terms of how organizations determine who receives variable pay, many organizations primarily use productivity measures. Several organizations also focus on performance evaluation scores and sales. Few organizations use customer service quality metrics to determine who receives variable pay.

Exhibit 3: Variable Pay Plan Metrics

Variable Pay Plan Metrics	
	Percent
Productivity measures	71.4%
Performance evaluation scores	57.1%
Sales	57.1%
Managerial discretion	42.9%
Customer service	21.4%

The average percentage of performance pay rewards allocated annually by most organizations is between 4-10 percent, with nearly 79% of organizations reporting rewards in that range.

Exhibit 4: Average Percentage of Performance Pay Rewards Allocated Annually

Average Percentage of Performance Pay Rewards Allocated Annually	
	Percent
4-6%	42.9%
7-10%	35.7%
11-20%	21.4%
1-3%	14.3%

EFFECTS OF VARIABLE PAY

Variable pay plans can have a positive impact on employee performance. Organizations report that performance was heightened most frequently for low performers as a result of using variable pay plans and second most frequently for average performers, indicating that performance may be positively influenced by using variable pay rewards.

Exhibit 5: Performance Increases as a Result of Variable Pay Plans

Performance Increases as a Result of Variable Pay Plans	
	Percent
Low performers	57.1%
Average performers	50.0%
High performers	35.7%

Variable pay plans can also create complications for organizations. Common difficulties cited by organizations when using variable pay are that rewards are seen by employees as unrelated to their individual efforts. Also, poor communication about the plan can also create barriers to its success. Still too, sometimes the plans can be too complex and inflexible.

Exhibit 6: Complications as a Result of Variable Pay Plans

Complications as a Result of Variable Pay Plans	
	Percent
Rewards seen as unrelated to individual effort	42.9%
Poor communication	35.7%
Too complex	28.6%
Not flexible enough	21.4%
Results in no difference in performance	21.4%
Rewards seen too small to be motivational	21.4%
Too expensive	7.1%
Too much time to operate	7.1%
Causes too much discontent among employees	7.1%

Organizations report that the most positive results of variable pay are that it delivers a clear message about the importance of performance and that it provides a way of rewarding employees for their performance. Over 40% of organizations also say variable pay helps to identify and get rid of bottom performers. Nonetheless, variable pay did not improve efficiency for these organizations.

Exhibit 7: Positive Results of Variable Pay

Positive Results of Variable Pay	
	Percent
Delivering a clear message about the importance of performance	71.4%
Rewarding employees	71.4%
Employee performance	50.0%
Identifying and getting rid of bottom performers	42.9%
Improved business results	35.7%

Enhanced customer service or product quality	35.7%
Encouraging employees to focus on the success of organization as a whole	28.6%
Employee retention	28.6%
Facilitating change	21.4%
Employee commitment	21.4%
Effective team performance	21.4%
Improved efficiency	21.4%

CONCLUSION

Variable pay plans play a critical role when rewarding employee performance. To ensure that variable pay is effective, it is important to use some best practices that commonly “make or break” the plan’s success:

- Develop clear metrics for determining performance pay allocation and communicate these metrics very clearly to employees.
- Make sure the metrics make sense for the stakeholders involved the plan, such as financial measures for executive employees or productivity measures for hourly employees,
- Provide a clear line of site between performance and reward allocated (i.e. the highest performers should receive the largest rewards).
- Make sure employees see how their behavior influences a performance measure and therefore the variable pay they receive.
- Ensure that variable pay plans are consistent with the compensation philosophy.
- Evaluate your plan. Make sure it is producing viable performance results for those involved and/or the organization.

For more information on how to implement an effective variable pay plan, please contact ERC at 440/684-9700.

Participation

23 organizations

Size

1-200 employees	69%
201-500 employees	9%
500+ employees	22%

Industry

Manufacturing	52%
Services	30%
Other	17%

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www.ercnet.org
 www.northcoast99.org
 www.erchealth.com

6700 Beta Drive, Suite 300 / Mayfield Village, OH 44143
 phone: 440/684-9700 • fax: 440/684-9760

email: hrhelp@ercnet.org; surveys@ercnet.org; consulting@ercnet.org