Lecture 5: Incentives and Motivation

Learning Objectives

· Define Incentive Plan
· List different Types of Incentive Plans
·Understand different incentives plans aspects

1. Incentive Definition

The term "**incentive**" (from Latin incentivum "something that sets the tune") indicates a tangible and/or intangible reward that motivates people and creates favorable environmental conditions to maximize performance and/or to achieve specific goals in organization or competition or society.

The concept of incentive in management and economics is developed from behavioral sciences (psychology, psychobiology, and cognitive science) to analyze and explain what motivates people in organizations and/or competition.

Motivation indicates the forces that energize, direct, and sustain behavior.

Motivation is: "*The set of processes that arouse, direct, and maintain human behavior towards attaining some goal*

2. Incentives Types

Incentives can be categorized as intrinsic and extrinsic incentives, which have different characteristics and different effects in organizations and/or society (Fig. 1).

INCENTIVES

***Intrinsic* incentives**

- Intrinsic incentives exist in the job itself and give personal satisfaction to individuals, such as autonomy, reputation, self -confidence, trust, empowerment, expense preference.
- Intrinsic incentives can satisfy personal needs directly by creating an intrinsic reward for those who perform the tasks.
- Intrinsic incentives may be important for affective commitment, job involvement and motivation in organizations.
- Intrinsic incentives can be effective in deterring corruption.

***Extrinsic* incentives**

- Extrinsic incentives are pay and fringe benefits, gifts, promotion, advancement opportunities, etc.
- Extrinsic incentives are important in relation to continuance commitment to organizations.
- Extrinsic incentives satisfy personal needs indirectly, because they lead to separable outcomes, such as monetary compensation. In fact, money cannot produce direct utility, but it enables an individual to acquire desired products.
- Extrinsic incentives can threaten the need for autonomy, competence, and relatedness, thus lowering intrinsic motivation (the crowding-out effect).

Comparative Incentive Systems, Fig. 1 Characteristics and effects of intrinsic and extrinsic incentives

3. Incentive Strategy Formulation Process

The organizations should follow a systematic process to formulate the incentive plans. Incentive Strategy Formulation Process involves the following steps:

- Organizations should first understand the need of incentive plans.
- They should set clear objectives as of why incentive plans are formulated, what are the objectives.
- These objectives should be in alignment with organizational goals and objectives
- Various options for individual and group incentive plans should be explored.
- Benefits and disadvantages of each plan should be considered and from the various options available one incentive plan should be chosen.
- Using the best incentive plan, compensation strategy should be formulated.

4. Types of Incentive Plans

The various incentives plans available are:

4.1. Basic Rate System

Basic rate systems are straightforward but may not provide incentives to individual workers. Under basic rate systems a worker is paid in relation to a given period of time – an hourly rate, weekly wage or annual salary. Generally this rate is the established rate for all workers in one category, but there are often incremental scales which allow for progression, perhaps as additional experience and skills are obtained.

✓ ***Suitability of Basic Rate System***

- All workers do identical or similar work
- The volume or quality of work is difficult to measure, or where the workflow is uneven
- Where the volume and/or pace of work is outside the workers' control
- Where high output is not as important as other considerations (eg quality, stable production levels).

4.2. Incentive Schemes for Individuals

On an individual basis this may be via:

- Payment by results (PBR)
- Work-measured schemes and pre-determined motion time systems
- Measured day work (MDW)
- Appraisal/performance related pay
- Market-based pay
- Competency and skills based pay.

4.2.1. Individual Payment by Results (PBR)

The aim of any PBR scheme is to provide a direct link between pay and output: the more effectively the worker works, the higher their pay. This direct relationship means that incentives are stronger than in other schemes. However, traditional bonus, piecework and work-measured schemes have declined in recent years, as many employers have moved to all-round performance rather than simple results/output based pay. Many bonus schemes incorporate quality measurements or customer service indicators in the assessment to avoid the likelihood of workers cutting corners or compromising safe working methods in order to increase output. Earnings may fluctuate through no fault of the individual. Supervisors and managers may fail in their responsibilities towards workers by inconsiderate allocation of work or using the incentive scheme to control output. Targets may not be accurate enough resulting in the perception of easy or difficult jobs. Material shortages or delays can affect production. Individual skills are not rewarded and indeed the most skilled may be put onto more difficult and potentially less rewarding work. In instances where workers regulate their own output to satisfy their individual needs production can be affected and forward planning made more difficult.

- ✓ **Piecework, Bonus Schemes**

Piecework is the simplest method of PBR – workers are paid at a specific rate for each ‘piece’ of output. This means the system is straightforward to operate and understand, although open to the disadvantages that quality and safety may be compromised to achieve a higher output. Pieceworkers must be paid at least the national minimum wage and there are special rules for working this out. Other individual PBR schemes include incentive bonus schemes where for instance an additional payment is paid when volume of output exceeds the established threshold, or where there is an increase in sales which exceeds given targets. Variable bonuses can also be paid in relation to performances achieved against predetermined standards so that the higher the performance achieved, the greater the level of bonus generated.

4.2.2. Work Measured Schemes

Work measurement is often used to determine target performances and provides the basis for many PBR schemes for shop-floor workers. In these systems, a ‘standard time’ or ‘standard output level’ is set by rate-fixers, or by work study, for particular tasks. Work study calculates a basic time for a task by using laid down methods, observing workers performing the operation and taking into account their rate of working. Incentive payments are then linked to performance or to the output achieved relative to the standard, or to the time saved in performing the task. As the setting of standard times usually includes an assessment of how the individual being studied is performing, which can have a significant impact on bonus earnings, such judgments often result in disputes. Organizations using this system often train trade union representatives in the technique to promote understanding of the way judgments are made.

An alternative is to use ‘pre-determined motion time systems (PMTS)’. In these systems a synthetic time for a job is built up from a database of standard times for each basic physical movement. A common form of this system is Methods Time Measurement (MTM). Allowances for relaxation and contingencies are then added to the basic time to form the standard time for the task. Such systems are arguably less open to dispute than work-measured schemes as long as the synthetic times upon which the standards are based are acceptable to the workers and their representatives. When the organization is considering the relationship of performance to reward there will generally be a starting point from which additional pay is attracted - performance at or below the starting point attracts no additional payment, but performance above the starting point attracts additional payment at a proportion of the basic wage or bonus calculator. Most schemes are ‘straight proportional’, which allow the reward to rise in direct proportion to the rise in performance. Schemes should include provisions covering the effects of downtime or other non-productive time on pay. Schemes should be controlled fairly and regularly reviewed to ensure there is no degeneration of work-measured standards. The operation of the scheme should be audited regularly. Arrangements need to be in place to accommodate changes in product, material, specifications and methods – re-measurement of the job may be necessary.

4.2.3. Measured Day Work (MDW)

Measured day work (MDW) is a hybrid between individual PBR and a basic wage rate scheme. Pay is fixed and does not fluctuate in the short term providing that the agreed level of performance is maintained. MDW systems require performance standards to be set through some form of work measurement and undergo revisions as necessary. Motivation comes from good supervision, goal setting and fair monitoring of the worker's performance. MDW is difficult and costly to set up and maintain. It requires total commitment of management, workers and trade unions. There must be effective work measurement and efficient planning, control and inventory control systems. A version of MDW is 'stepped' MDW. Under this scheme the worker agrees to maintain one of a series of performance levels and different levels of pay apply to each one. Movement between levels is possible, usually after a sustained change in performance. MDW is now relatively rare. It suits organizations where a high, steady, predictable level of performance is sought, rather than highest possible individual performance. MDW may be worth considering where stability of earnings is important, or where the manufacturing cycle is lengthy.

4.2.4. Appraisal/Performance Related Pay

Appraisal/performance related pay is generally used to link progression through a pay band to an assessment of an individual's work performance during a particular reference period, often a year. Alternatively, the reward may be an additional sum of money paid in the form of a bonus. Assessments usually relate to an individual's achievements against agreed objectives relating to output and quality of work but may also include an element of evaluation of personal characteristics, such as adaptability, initiative and so on.

Linking pay to appraisal can also have the disadvantage of turning the appraisal into a backward looking event where assessments are made and where workers may become defensive, as opposed to using the appraisal to look forward and agree new objectives, discuss development and any training needs. Where pay is at stake the individual may be less receptive to work counseling and may seek to negotiate softer objectives at the outset.

If a worker rated 'less than satisfactory' receives no increase at all under an appraisal pay scheme their motivation and morale may be adversely affected. It is important therefore to focus appraisals on the assessment of performance, the identification of training needs and the setting of objectives, not on any dependent pay. Any organization that chooses appraisal related pay should have good industrial relations and good communications systems in place.

It is also important that the finance necessary to operate the scheme is available. Appraisal related pay is most successfully introduced when it is linked to an existing appraisal scheme that is working well, rather than a simultaneous introduction of appraisal and appraisal related pay. It is important to monitor the appraisals, to pick up any drift from the overall distribution of ratings and to check the fairness, equity and consistency of the ratings.

4.2.5. Market-Based Pay

Market-based pay links salary levels, and progression through the scales, to those available in the market. It is often used in conjunction with a performance pay matrix, which allows faster progression from the bottom of the scale to the market rate, which will be the mid-point. Progression then slows, regardless of the performance of the worker, as they are deemed to be earning above the market rate for their job. It is rarely used as a scheme in isolation, but may be part of a reward strategy incorporating several performance elements.

4.2.6. Competency and Skills-Based Pay

Competency and skills-based pay schemes have increased in popularity in recent years. A direct link is created between the acquisition, improvement and effective use of skills and competencies and the individual's pay. Competency and skills-based schemes measure inputs, ie what the individual is bringing to the job, unlike traditional performance based schemes which measure outputs. Competency may be generally defined as the ability of an individual to apply knowledge and skills and the behaviors necessary to perform the job well. Competency based systems have become more wide-spread because many organizations already use competencies in recruitment and in performance appraisal for non-pay purposes, such as development and training. It goes along with the increasing tendency for pay to be linked to the abilities of the individual rather than a single set rate for the job. Competency based pay is often used in conjunction with an existing individual performance related pay scheme and will reward on the basis of not only what the individual has done, but how they have achieved their targets. Examples of competencies may include leadership skill, or team-working ability. Competency-related pay fits well with an overall organizational philosophy of continuous improvement.

Difficulties may arise in defining the competencies valued by the organization.

There are differences between behaviors that are in-built and those that can be developed.

Problems may also arise because of the complex nature of what is being measured and the relevance of the results to the organization. Judgments about people's behavior may be less than objective. Competency assessment rests on several factors - identifying the correct competencies, choosing the right form of assessment and crucially, training the assessors to make accurate, objective judgments. Skills-based pay also rests on workers gaining new and improved skills - often in a manufacturing environment. Reward is given for skills that can be used in other jobs in the same job band, encouraging multi-skilling and increased flexibility. Workers may also be allowed to develop the skills of a higher job band. Skills may be based on National Vocational Qualifications or internal evaluation and accreditation.

4.3.Incentive Schemes for Groups/ Team Compensation

4.3.1. Team-Based Pay

While team-based pay has been around for some time - in the shape of departmental or group bonus systems - it has taken on more importance with the increased interest in team working. In team-based pay systems the payments reflect the measurable goals of the team. Team working may be most effective in situations involving high task interdependence and creativity, although it can be difficult to define the team, the goals, and the appropriate reward. Schemes can be divisive if they are not open and transparent. Goals should not be shifted once agreed - they need to be achievable.

The aim of team-based pay is to strengthen the team through incentives – building a coherent, mutually supportive group of people with a high level of involvement. The team achievements are recognized and rewarded. Peer group pressure can also be helpful in raising the performance of the whole team. As with any other pay system, involvement of the workers who will be affected is crucial in the design of the scheme. They must be involved particularly in the way objectives are set, how performance is measured, and the basis on which team rewards are distributed.

4.3.2. Plant or Company Based Pay / Enterprise Incentive Plan

Plant or company based performance pay schemes are based on larger groups than teams, for instance, divisional, plant or the whole organization. They may well use the same factors as team-based or individual performance schemes, or perhaps total sales within a set period, or comparative reductions in labor costs. The most common forms of plant or company based payment systems tend to be based on overall profits (profit sharing), or alternatively on schemes that owe more to the improvements within the direct control of the workforce, such as added value or similar types of gain sharing systems. Overall profitability in an organization is subject to factors outside the workforce's control, such as depreciation, economic changes, taxation, as well as the productivity improvements of individuals and therefore may not reflect real efficiency gains by the workforce. Plant/company based pay schemes are generally most effective in organizations where the workforce can clearly see the results of their efforts. They are successful where communications and employment relations are good and where the performance measurement is not subject to major changes arising from external causes.

4.3.3. Gain Sharing Incentive Plan

Gain sharing is a form of added-value pay scheme linking workers' pay to the achievement of organizational goals by rewarding performance above a pre-determined target. This may be in the form of a share in the profits generated by sales, or on measures of customer satisfaction, but is almost always led by measures of productivity, performance and quality. Gain sharing schemes have to be based on factors that are in the workers' control. Gain sharing should be part of a long-term strategy to improve communications, staff involvement and teamwork.

The goal is not to work harder, but more effectively. It may be used as a replacement for bonus/piecework schemes, where quality is sometimes lost to quantity. All workers and management who have any involvement in the product of the organization should be included in any gain share plan. In this way their support is encouraged so that they can feel a direct responsibility for the plan's success. Performance measures and results should be made available and everyone encouraged offering suggestions for improvements. Open communications and exchange of information are crucial. Common types of gain sharing schemes include:

a. Scanlon Plan

➢➢ This formula measures labor costs as a proportion of total sales and sets a standard ratio which will trigger some distribution of savings to a pre-established formula.

b. Rucker plan

➢➢ This is a refinement of the Scanlon plan which measures labor costs against sales less the cost of materials and supplies and provides a simple added-value calculation.

c. Other gain sharing / value-added schemes

➢ There are several forms which further refine the calculations and link bonus payments to the increase in added value, above a given norm. Value-added deducts wages and salaries, administration expenses, services and materials from income derived, and thus represents the value added by the production or other process within the organization. The level of added value of an enterprise is an indicator of its efficiency.

d. Share Incentive Schemes

Share incentive schemes involve the provision of shares to employees - either by giving them direct or allowing them to be bought. The aim is to encourage staff involvement in the company's performance and therefore improve motivation and commitment. The Share Incentive Plan (previously the All-employee share ownership plan (AESOP)). SIPs can include four types of shares:

➢➢ Free shares

➢➢ Partnership shares

➢➢ Matching shares - companies can reward this commitment by giving up to 2 matching shares for each partnership share an employee buys

➢➢ Dividend shares - companies can provide for dividends paid on free shares, partnership shares and matching shares to be reinvested in further shares

Examples of other share incentive schemes include:

➢➢ Savings Related Share Option Schemes (SAYE)

➢➢ Enterprise Management Incentives (EMI)

➢➢ Company Share Option Plans (CSOP)

Although share-owning schemes can appear attractive to employers it is not always helpful to a company's finances to have a constant turnover of shareholders. Companies therefore need to be clear about how much of the equity can be held in this way and how to create ways to get workers to keep their shares long-term.

e. Executive Incentives

Ex Organizations offer heavy incentives to executives to retain the talented workforce.

The immense competition in the market has forced the organizations to offer lucrative compensation packages. Performance based incentives comes out to be the only solution for the demand-supply disparity. Who works- receives the appreciation and who does not works- lacks behind. Executive Incentives are more effective in the marketing segment as it results in more and more sales. The business development executives strive for more incentives and in the effort produce more business and receive heavy perks.

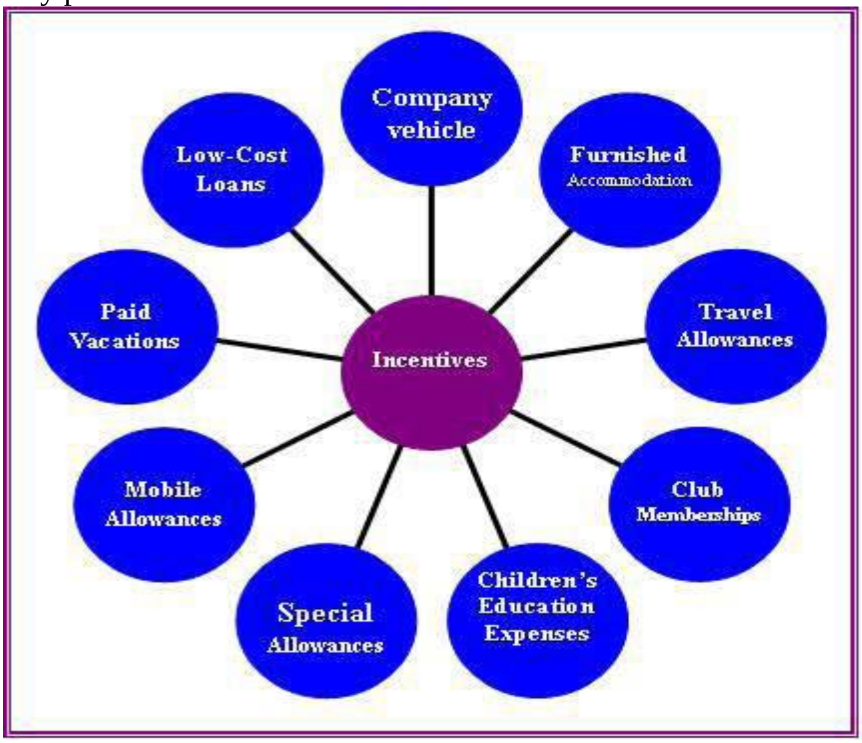

Fig 1 Executive Incentives

References:

1. Mario, C. (2019), Comparative Incentive Systems, Springer Nature Switzerland.

2. Arul, P. G. (2003), Compensation Management, Pondicherry University, Department of International Business, MBA – HRM, Private Circulation.