Pay: How to Design a More Effective Compensation Plan

Financial incentives alone may not be the best way to motivate employees. Guido Stein and Carlos Anta dissect pay policies and explain how to design a more successful compensation plan.

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Most believe that financial rewards are the main motivation for meeting objectives and performing well at work. That means managers tend to focus their efforts on establishing the best payment schemes.

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However, while financial incentives do work, business experience also shows that they can, at times, be counterproductive and cause frustration.

This is addressed by IESE professor Guido Stein and Carlos Anta in their book on employee compensation as a leadership tool. They analyze the ins and outs of pay policy and outline various successful incentive schemes.

The Pros and Cons of Variable Pay

There are three common arguments in favor of introducing specific financial incentives, i.e., variable pay: (1) that payments motivate employees to meet objectives; (2) that they provide a vehicle for communicating the company's aims and priorities; and (3) that they enable businesses to attract and select the best professionals.

Yet, especially in recent years, questions have been raised over the effectiveness of variable pay. According to some critics, financial rewards or bonuses can help meet objectives in the short term but are unlikely to result in the desired level of motivation — and may even breed a perception of unfairness — unless the variable pay schemes are flawlessly designed.

Poorly designed variable pay schemes also lead to undesired behaviors and outcomes. Recent scandals in the banking sector, for example, have highlighted the dangers of rewarding short-term gains without looking ahead to long-term sustainability and heeding regulations.

Designing an Incentive Scheme

For the book's authors, design is key. A good incentive scheme should balance the attraction and motivation of talented employees alongside meeting company objectives.

The first step is to analyze the business strategy and identify the behaviors that managers wish to incentivize. The design team must involve all relevant departments and glean an in-depth understanding of the significance of company growth or profit objectives, market position, the current stage of the product lifecycle, and the positions of competitors. Then, management must define the various elements of the scheme: the type of variable pay, the objectives to be incentivized, the metrics to measure performance, and the pay formula.

The *raison d'être* of incentive schemes is to guide behavior. For that reason, the authors maintain that any scheme is only as effective as its communication plan: communication is crucial. Managers must inform employees about the scheme from the outset and draw attention to the desired outcomes — e.g., the volume of sales, the profitability of sales or eventual profits.

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The Keys to Success

Once a compensation plan has been implemented, management should review its results, calculating the total due to each employee and the company's return on investment. Furthermore, to improve the plan's design and implementation, detailed data should be analyzed — including employees' views on the scheme's strengths and weaknesses.

Summing up, the authors say the keys to successful compensation plans are: a design that aligns with business objectives, communication that emphasizes the reasons behind it, and effective implementation to reinforce motivation.

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