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# Bonuses and incentives

Understand the basics of bonuses and incentives, the trends in their application, and how to design and operate schemes effectively and ethically

## Introduction

Whether used proactively to influence behaviour or retrospectively as part of a reward package, bonuses and incentives can have various benefits for organisations and employees. However, the impact of any bonus or incentive scheme is based on an awareness of the various factors needed for success and an understanding that individuals may respond differently to the same stimulus.

This factsheet explores the types of bonuses and incentives, trends in their use, and their potential benefits and drawbacks. It also explores the latest research evidence and implications and the possible implications for the design and implementation of bonuses and cash or non-cash incentive schemes.

See the **full A-Z list of all CIPD factsheets**.

## What are bonuses, financial incentives and non-financial incentives?

Bonuses and financial incentives are a form of variable pay based on lump-sum payments linked to individual, collective or organisational performance (or some combination of these). They are not consolidated into base pay, though in certain situations (such as due to cost constraints) they can be given as part of, or instead of, a pay rise. They are often paid in cash, but senior employees often receive some of these rewards in company shares.

It's important to draw a distinction between incentives and bonuses, although the two terms are interlinked and often used interchangeably.

- **Incentives** aim to influence future employee behaviour or performance, usually

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using targets: if a specific target is met, the employee will receive a payment, typically of a specific size.

- **Bonuses** cover a wider range of purposes and can be discretionary or non-discretionary. Like incentives, they may be used to influence employee performance or behaviour to meet pre-set objectives, but they could also be used to reward past achievements.

It's also helpful to differentiate between:

- **Non-cash incentives**, sometimes known as performance improvement plans, are forward-looking, formal schemes. They aim to affect employees' future performance by awarding prizes or 'gifts', such as merchandise, travel or retail vouchers, associated with some performance measure, such as sales volume.

- **Employee recognition schemes** are retrospective as they recognise past performance rather than incentivising future efforts. They may be informal and discretionary. Such schemes may be linked with non-cash incentives.

Our report Show me the money! The behavioural science of reward examines recent thinking on how individuals can respond to various kinds of incentives.

## The purpose of bonuses and financial incentives

The desire to incorporate bonus and incentive plans into reward packages has been driven in part by the 'new pay' philosophy. This advocates that 'guaranteed' remuneration (basic pay and benefits) should comprise a smaller proportion of the overall reward package, with a shift towards strategic reward linking employee performance and pay to the wider business strategy.

There's also been a move in certain sectors towards market-based pay, whereby an employee might only receive a pay rise if the market rate for the role had increased: in this scenario, individual contribution could be recognised via a bonus instead of a pay rise.

For the employee, the main benefits of bonuses/cash incentives over consolidated salary increases are:

- Greater control over their level of remuneration.
- Higher payments are potentially possible.

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- The bonus can be received in one go.

But the downside for employees includes:

- Non-consolidated payments must be re-earned and may not count towards variable payments (such as overtime) or benefits (such as occupational sick pay).
- Payments may be unpredictable or lower than expected if targets cannot be met.

For the employer, the advantages include:

- Ongoing motivation as bonuses must be re-earned.
- Lack of impact on certain employer on-costs that are linked to basic salary levels, such as pension contributions.
- Capacity for maintaining market pay competitiveness without necessarily inflating the annual pay bill.
- Flexibility through, for example, the ability to reduce or even halt payments during economic downturns.

There are also challenges for employers. While money influences behaviours, it may encourage the wrong types. So, any financial-based bonus or incentive scheme must be designed carefully and align with an organisation's business objectives, corporate governance, and ethical standards as well as the views of key stakeholders, such as employees, or customers. However, this can lead to a proliferation of checks and balances, such as malus or clawback, which may reduce the motivational impact.

The success of these schemes also depends on how effectively performance is defined, managed and ascribed, requiring effective communication and support for both line managers and employees.

# Types and coverage of bonuses and incentives

Payment of bonuses and incentives is generally linked to the quality and/or quantity of work on an individual or collective basis, or to some measure of company performance such as profit levels (or both).

Schemes may be broadly divided into the following categories although definitions vary, may overlap or be linked.

- **Individual-based** - Payment of the bonus/incentive is calculated by some measure of individual performance, hence there should be a considerable incentivisation effect. Sales commission could be included within this category (although this may be seen as a distinct form of remuneration in its own right).

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- **Schemes driven by business results** - Company profit levels or customer satisfaction may be used as measures to help determine bonuses.
- **Team-based** - Links the bonus with some measure of collective performance, often with the aim of fostering effective teamworking.
- **Project-based** - Might be used when a deadline is important, for example to reward construction workers for completing a building project on time.
- **Department/site-based** - Payments that could be used to reward, for example, workers who attain productivity improvements in one factory.
- **Gainsharing** - Employees share in financial gains achieved through improved performance (particularly enhanced productivity).
- **Combination** - Two or more of the above schemes, for example a scheme driven by a combination of both individual and team performance.

There are other more specialised bonuses, for example at Christmas or for attendance.

Our 2019 Reward management survey found that many employers use some form of cash-based bonus or incentive plan. However, such schemes are far more common in private sector than in the public or voluntary sectors. The most popular arrangements include individually based plans (for example, personal performance or commission), plans driven by business results (such as profit) and combination schemes.

### CEO bonuses and incentives

Despite the growth of interest in environmental, social and governance investing, most FTSE 100 executives' bonus and long-term incentive plans are weighted towards financial measures of company success. By contrast, non-financial measures, such as workforce ones, play a minor, albeit growing, role. See our CEO pay and the workforce report for more.

## Bonus payment levels and recent developments

### Levels of payments

If they are to affect employee behaviour or performance, bonus or incentive payments

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need to be 'worth having'. That means they must be set at a high enough level to have an effect, and consider (though not be driven by) market practice. By contrast, setting bonuses at very high levels needs caution to avoid encouraging undesired behaviours or outcomes, such as taking on more risk or mis-selling.

An important factor in calculating any incentive is that it's kept simple. Ideally, employees in the plan should be able to measure progress against targets and carry out the calculation themselves so they know how they're progressing and what payment level they might achieve.

Employers need to decide how they'll set bonus payments, including whether to use a formula (typically for incentives) and how to express payments (for example, as a salary percentage or a flat-rate payment).

Information tracking specific breakdowns of UK bonus payments over time (by gender, for instance) can be found in the Office for National Statistics' Annual Survey of Hours and Earnings.

## Recent developments

Following the 2008 recession, bonuses in the UK became a concern with their whole nature and operation questioned. The Financial Services Authority (FSA) considered that remuneration practices were a 'contributory factor to the market crisis'. Practices in investment banking in particular tended 'to reward short term revenue and profit targets' and, in so doing, 'gave staff incentives to pursue unduly risky practices'.

A range of measures were introduced to regulate remuneration in the finance sector, particularly for senior pay. The EU's Capital Requirements Directive known as CRD IV requires finance sector bonuses to be limited to 100% of base pay, or 200% with the approval of at least 66% of shareholders. The regulation covers senior banking employees irrespective of their location, so those staff working for a European firm but based in Asia would still be subject to the cap.

While many reward specialists believe there needs to be a continuing clear link between high levels of performance and bonus payments, without rigour in applying this principle, bonuses may reward less-than-robust performance or incentivise inappropriate behaviour. Corruption is one example which, according to a Transparency International report Incentivising ethics: managing incentives to encourage good and deter bad behaviour, can include fraud, trading in influence, anti-competitive practices and the offering, promising or payments of bribes. For incentives to work as intended and avoid distorted outcomes, it argues that employers should have an open and ethical culture in which staff are encouraged to do the right thing and feel able to challenge management

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decisions or targets they think are unethical or dysfunctional. See more in our factsheet on ethical practice and the role of HR.

### The impact of the coronavirus pandemic

Our 2020 Reward management survey finds a large proportion of employers have made temporary changes to their bonus plans due to COVID-19 and the economic lockdowns, such as moving the emphasis from performance to behaviours, lowering certain targets or suspending them.

#### Do such plans work?

Given the widespread use of bonuses and incentives, both in the UK and overseas, the assumption must be that they do work. Otherwise, why would employers be using them? This assumption is backed up by the CIPD report Incentives and Recognition: An evidence review, which shows research evidence that such arrangements can motivate employees and boost their performance. However, the report also finds that the success of these kinds of financial rewards depends on several factors, namely how performance goals are set; the type of tasks being encouraged; how fairly employees view the process and outcomes; and the approaches used to allocate rewards.

For example, our report finds strong evidence to show that team-based incentives do more to drive performance than individual ones. However, this does not mean that everyone within a team should be rewarded the same: the research indicates that distributing rewards equitably within teams – that is, fairly considering individuals' contribution – is more effective than distributing them equally or uniformly. The upshot is that a balance needs to be struck, such that people are incentivised within teams, yet also depending on their individual performance.

## The purpose of non-financial incentives

Because cash may not always be the most effective means of motivating employees as it doesn't necessarily encourage them to 'go the extra mile', non-financial incentive schemes, based on the receipt of a gift or prize, could be more memorable and exciting, and therefore have greater impact.

Typically found in customer-facing industries, non-financial incentives may be a single prize won by the highest-performing employee or team, or a range of awards recognising different levels of achievement.

The benefits include:

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- **Affordability** - They may be more cost-effective than cash bonuses.

- **Simplicity** - It's easy for a sales employee to understand that, say, selling so many phones will result in them receiving whatever the latest prize is.

- **Psychological impact** - It's acceptable for employees to speak openly with pride about the winning of gifts in a way that may be considered by many to be socially unacceptable if they were seen to be 'bragging' about their cash bonuses.

Drawbacks can include:

- **Lack of credibility** - Such prizes may not be taken as seriously as cash.

- **Lack of employee awareness** - Employees may be less conscious of the value of non-financial incentives over 'hard cash'.

- **Lack of value** - People value the same non-financial reward, such as a trip to a sporting event, differently, so what might be an incentive to one person might not to another.

The incentivisation industry is more highly developed in the USA than in the UK where, according to our 2019 Reward management survey, only a minority of employers have non-financial incentive schemes.

# Designing and operating non-financial incentive schemes

## Types of non-financial incentives

The main types of non-financial incentives may be broadly divided into:

- **Merchandise** such as tablets, mobile phones or watches.
- **Activities/special events** such as meals out, hotel spa accommodation/treatments or a trip to a sporting event.
- **Travel** such as an all-expenses paid trip.
- **Retail vouchers** which are often obtainable at a discount to 'face value'.
- **Awarding points** that may be converted into a range of awards.

The last two of these categories might not be strictly regarded as 'non-cash' items.

## Incentive suppliers

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There are many suppliers of non-cash incentives. They often provide a wide-ranging service offering employee non-cash incentives as well as other schemes such as recognition and team-building activities. There's more information in the journal Incentive and motivation.

## Tax implications

Employers must consider any tax implications of implementing a non-financial incentive scheme as they can be subject to income tax over a certain level. It's possible for UK employers to arrange payment of any tax or national insurance owing on behalf of employees. Information on the UK tax implications of non-financial awards can be found in HM Revenue and Customs guidance.

## The purpose of recognition

By recognition we mean personal non-monetary rewards given to employees to acknowledge and reinforce their efforts, behaviour, or achievements. Its usually set retrospectively, so is unexpected, and is relational and unconditional. Examples include giving personal compliments, positive feedback, or thanks, announcing achievements, or presenting awards. It can be given verbally, via a thank-you card, company newsletters or noticeboards, or even with emojis. The extent to which there is a climate of recognition in an organisation can be measured by asking employees how well recognised they feel by their manager or organisation – for more see our report Incentives and Recognition: An evidence review.

An explanation of the value of recognition comes from social comparison theory. This argues that we compare ourselves with others to build our self-esteem: it is nice to see that we at least measure up to our peers. Recognition makes use of this fact to make people feel good and it is our desire for such acknowledgement that motivates us.

### Do recognition schemes work?

Our 2019 Reward management survey finds significant use of individual or team-based non-financial recognition, especially in the public and voluntary sectors. If such schemes didn't work, then they wouldn't be so widespread. This assumption is backed up by the evidence from our report Incentives and Recognition: An evidence review. In general, it shows a strong body of research indicating that recognition and non-financial rewards have a positive impact on intrinsic motivation and performance. As with financial incentives, the impacts are moderate to large. Recognition is also seen to affect other related outcomes, including employees' interest in and enjoyment of work, attendance, and to some extent employee retention, commitment, and work engagement. What's

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more, if an employee is given recognition, it can have a knock-on effect, improving not only their own performance, but also that of their colleagues or team.

# Further reading


## Books and reports

ARMSTRONG, M. (2019) *Armstrong's handbook of reward management practice: improving performance though reward*. 6th ed. London: Kogan Page.

COTTON, C., GIFFORD, J. and YOUNG, J. (2022) Incentives and recognition: an evidence review. Practice summary and recommendations. London: Chartered Institute of Personnel and Development.

PERKINS, S.J. and WHITE, G. (2020) *Reward management: alternatives, consequences and context*. 4th ed. London: Chartered Institute of Personnel and Development.

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## Journal articles

COTTON, C. (2020) CEO pay: complex solutions for complex problems. *CIPD Voice*. Issue 26. 16 November.

PARK, S. and STURMAN, M.C. (2012) How and what you pay matters: the relative effectiveness of merit pay, bonuses and long-term incentives on future job performance. *Compensation and Benefits Review*. Vol 44, No 2, March/April. pp80-85.

SHAW, J. and GUPTA, N. (2015) Let the evidence speak again! Financial incentives are more effective than we thought. *Human Resource Management Journal*. Vol 25 No 3, July. pp281-293.

TAYLOR, T. (2010) The challenge of project team incentives. *Compensation and Benefits Review*. Vol 42, No 5, September/October. pp411-419.

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