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ENGAGED MANAGEMENT ReView

Motivating Increased Sales: Variable or Fixed Compensation Structure?

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EDITORIAL NOTE

Our knowledge of the relationship between employee compensation and performance has developed through years of research and practice. But how much of this knowledge is founded on evidence, how much is just common sense, and how much is folklore? In this article, Kevin Chalk provides a viewpoint on the evidence behind decisions to offer employees fixed or variable compensation. The article approaches the topic as a critically appraised topic (CAT), a framework that seeks to punch through the noise around the subject, identify the evidence, critically review it, and make a recommendation to practice. Given the broad interest, such a task is made feasible because several respected literature reviews became available in the past decade or so. Chalk analyzes these together with recent empirical works. As with many CATs, Chalk aims to provide advice regarding a specific practice; advice based on evidence in the research literature. Is there evidence that variable compensation works, yes or no? In this case (actually, like many cases) the outcome confirms the practice in some situations, but denies it in others. Variable compensation is not *always* the best incentive. The answer is conditional: *it depends.* The important question Chalk answers is, *on what*?

ABSTRACT

This topic paper examines the question of whether a variable compensation structure helps motivate increased sales more than a fixed compensation structure. The analysis is based on peer-reviewed articles focused on compensation and incentive structures and performance measurement. Our findings suggest that variable compensation can increase sales performance—but only to a certain degree. A proper compensation structure would be a combination of both variable and fixed components.

RESEARCH QUESTION

Does a variable compensation structure help motivate increased sales more than a fixed compensation structure?

Table 1: PICOC Format

P = Problem or Population	Organizations that have a sales performance metric but less than optimal results
I = Intervention or Success Factor	Increased sales results by aligning compensation, organizational goals, and culture more closely with employee goals
C = Comparison	Compare the sales performance using a variable compensation structure vs. a fixed compensation structure
O = Outcome	Increased motivation among sales professionals to meet organizational sales performance metrics
C = Context	Organizations employing sales/business development professionals

BACKGROUND

Sales force turnover is an issue that most organizations face at one point or another. Some firms consider themselves fortunate if they retain 50% of new sales people for two or three years. When adding together the costs associated with onboarding a new hire and the costs associated with unrealized sales (because of the transitions involved in staffing changes), total costs for some firms can range from $50,000 to $75,000 per salesperson (Futrell and Parasuraman, 1984). One of the issues related to turnover stems from compensation (Darmon, 2008). Sales-oriented organizations often face the complex decision of how to appropriately compensate their sales force. Organizations must consider various factors when deciding the most effective compensation and incentive structure, including the organizational life cycle (i.e., start-up, growth, maturity, or decline) of the organization (Madhani, 2010), the organizational culture (Madhani, 2014), and the ever-evolving competitive landscape. Deo (2011) stresses that, regardless of the pay structure an organization chooses to adopt, that structure should attract the right talent and should not be so costly that it creates a disadvantage for the organization compared to similar firms in the respective industry.

Madhani (2010) defines fixed pay (base pay) as a noncontingent reward that is not tied to the completion of a specific task. It is simply pay for participation. Variable pay[1] (also called incentive pay in some of the literature) is a performance-contingent reward, where the amount is variable and requires a specified quality of performance. When base pay is coupled with a bonus payout, this fixed compensation structure can be an attractive one for some sales professionals because the base pay structure provides a compensation "floor" when the sales funnel begins to slow. However, a base pay structure can be expensive for smaller, start-up organizations (Madhani, 2010), and in some instances the base salary can create performance issues for sales professionals that are not motivated by incentives tied to sales results. This topic paper examines the current literature to explore whether a compensation structure that either consists of or includes a variable (incentive) component helps to increase sales results compared to a fixed (base) compensation structure.

[1] The terms variable pay, incentive pay and incentives are used interchangeably.

SEARCH STRATEGY

A stepwise method was used to search for relevant articles in three databases: EBSCOhost, ABI/Inform, and Business Source Complete. We chose these databases because they provide access to many peer-reviewed business journals. Initially, the research question was used as the initial search query, which returned the following results: EBSCOhost provided 35,400 results; Business Source Complete provided 2 papers; and ABI/Inform provided no results. To expand the results from the ABI/INFORM and Business Source Complete databases (and to refine the results from EBSCOhost), the following set of terms was used as Boolean search criteria:

- Fixed and variable compensation structures OR fixed and variable incentive structures AND performance measurement.

When we implemented the refined search criteria, EBSCOhost gave 10 results; ABI/INFORM gave 267,745 results; and Business Source Complete gave 2 results. To further refine the results from ABI/INFORM, we screened the findings using the following criteria: 2010–present; English; United States; wages and salaries; and employment or employees. The additional screen for the ABI/INFORM database provided results of 425. The third screen of "peer reviewed" was added to each database's findings, and in these results, EBSCOhost provided 6 titles; Business Source Complete provided 2 titles; and ABI/INFORM provided 368 titles. The titles of each data set were reviewed to identify relevance; the review resulted in four articles being chosen from ABI/INFORM and one article from both EBSCOhost and Business Source Complete. The search strategy is displayed in Figure 1; Table 2 provides the final search results.

Table 3 lists each of the articles by author, research approach, empirical basis for the research, analytical method, and overall validity. Based on the seminal works of Milgrom and Roberts (1992) and Laffont and Martimort (2001), Boyer (2011) uses a behavioral model to derive some general principals in setting up an incentive pay system. Deo (2011) formulates a framework for a compensation structure by performing an extensive review of related literature and then implementing the compensation structure based on a Fortune 500 company (Deo, 2011). Both Dohmen and Falk (2011) and Friebel et al. (2017) study the effect of incentives by designing controlled laboratory experiments. Dohmen and Falk (2011) state that experiments are ideal for studying how individual characteristics affect decision making, relative to incentives, because relevant data is difficult to collect in the field. In addition to conducting an extensive literature review, Madhani (2010, 2014) constructs several frameworks based on the literature reviewed to support the incentive structure claims.

Figure 1: Search Strategy

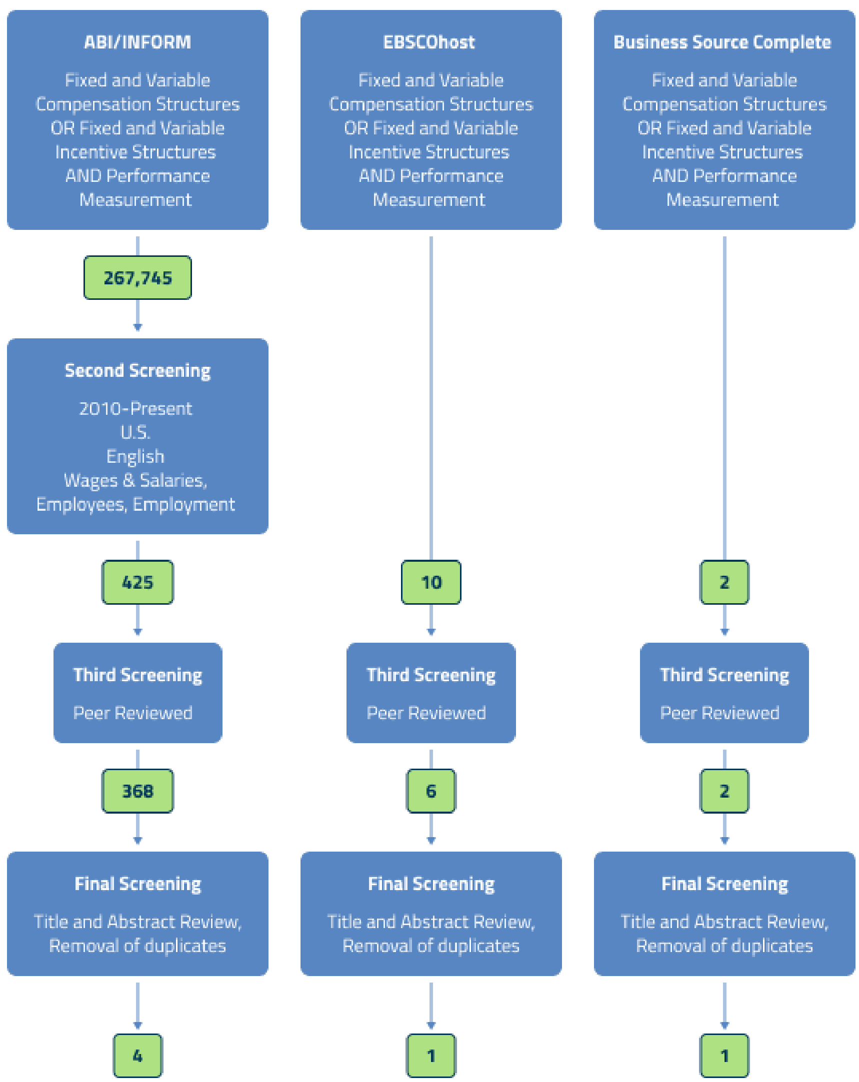

Table 2. Search Results

1	Boyer, M. (2011). The twelve principles of incentive pay. ***Revue d'économie politique***, 121(3): 285–306.
2	Deo, P. S. (2011). Designing performance-based incentives. Part I: A framework. ***Corporate Finance Revie***w, 16(1): 18.
	Deo, P. S. (2011). Designing performance-based incentives. Part II: Implementation. ***Corporate Finance Review***, 16(2): 10.
3	Dohmen, T., & Falk, A. (2011). Performance pay and multidimensional sorting: Productivity, preferences, and gender. ***American Economic Review***, 101(2): 556–90.
4	Friebel, G., Heinz, M., Krueger, M., & Zubanov, N. (2017). Team incentives and performance: Evidence from a retail chain. ***American Economic Review***, 107(8): 2168–2203.
5	Madhani, P. M. (2014). Aligning compensation systems with organization culture. ***Compensation & Benefits Review***, 46(2): 103–15.
6	Madhani, P. M. (2010). Realigning fixed and variable pay in sales organizations: An organizational life cycle approach. ***Compensation & Benefits Review***, 42(6): 488–98.

Table 3. Evaluation of Overall Validity

Study #	Research Approach	Empirical Basis	Analysis Method	Overall Validity
1-Boyer, M. (2011)	Formal modeling	List of 12 incentive pay principals	Inductive reasoning based on behavior and economic models	Conclusions drawn based on application of 2 models
2-Deo, P. (2011)	Literature review (Part 1), Case study/ literature review (Part 2)	47 referenced works consisting of journals, articles, interviews, and URLs (Part 1); Fortune 500 company (represented by a fictitious name) used as a case study (Part 2)	Analysis of literature to design an incentive structure framework (Part 1); analysis of literature to propose an annual performance-based incentive design based on a case study (Part 2)	Conclusion and recommendations drawn through literature review
3-Dohmen and Falk (2011)	Experiment	12-step work task experiment involving 360 participants asked to self-select into variable-pay or fixed-pay schemes	Statistical inference	Statistically significant findings; limitation: participants were students
4-Friebel et al. (2017)	Experiment	Retail chain involving 1300 sales employees across 193 stores	Statistical inference	Conclusions drawn from data
5-Madhani, P. (2014)	Literature review	25 referenced works, to include peer reviewed journals, articles, and published books	Theoretical inference	Conclusion and recommendations drawn through literature review
6-Madhani, P. (2010)	Qualitative theoretical paper	63 referenced works, to included peer reviewed journals, articles, and published books	Theoretical inference	Conclusion and recommendations drawn through literature review

FINDINGS

Table 4 summarizes the key findings from each paper with a summary translation of the collective findings. There are four main themes that emerge from a review of the articles: time, organizational objective and culture, productivity, and risk-taking.

Important elements to consider in relation to compensation are the nature of the performance measurement (short-term or long-term) and the timing of the incentive pay. Madhani (2014) states that when organizations create a structured and more formalized workplace environment, they typically have a longer-term focus and therefore put a greater focus on fixed pay structures. Madhani (2010) explains that a larger focus on variable pay can cause salespeople to become short-sighted (more individually focused) in terms of how they spend their time. Deo (2011) elaborates further, stating that incentives should place an emphasis on both long-term and short-term performance, with longer term performance focused on overall company goals and shorter-term performance focused on individual goals. Deo (2011) also points out that the method of payment for short-term incentives should be in the form of cash, while longer term incentives could be in the form of company stock. The timing of the payment is a key element to consider as well. Boyer (2011) explains that the effect of an individual's performance must be considered when implementing an incentive pay system. For example, individual contributors who achieve short-term goals should receive their incentive compensation when the goals are met. In summary, time is a key element—whether relating to long-term and short-term organizational objectives or to when incentive payments are made—to consider in the evaluation of incentive pay structure. Variable compensation should be focused on shorter term individual goals, while fixed compensation is better suited for longer term organizational goals.

Organizations have unique goals and objectives that are created to help guide the activities of employees. Also unique to the organization is its culture. Both the organizational goals and objectives and the organizational culture are key themes that emerge in the selected articles. Deo (2011) states an effective compensation strategy design should include both fixed and variable components to inspire employees to achieve firm objectives. Similarly, Madhani (2010) states that a combination of fixed and variable pay attracts the best talent and provides sufficient motivation. Friebel et. al (2017) point out that organizations can motivate underperforming teams by implementing a properly structured incentive plan. Dohmen and Falk (2011) point out that changing the compensation system potentially can change the firm culture. In addition, when the proper balance between firm culture and compensation strategy is achieved, the synergy becomes a competitive advantage (Madhani, 2014). The common element across each paper, relating to organizational goals and objectives and culture, is the conclusion that a combination of both variable and fixed pay offers the best opportunity to achieve the desired performance results and to create the best firm culture.

Productivity is the third theme that emerges across several of the papers reviewed. Madhani (2014) describes the differences in organizational culture where the emphasis is on more variable compensation vs. fixed compensation; in addition, the individuals who succeed in these types of organizations are different. In terms of productivity, organizations that focus on high-volume, ongoing business development might attract more productive workers compared to organizations that seek to develop deep customer relationships. In other words, when faced with an alternative between variable compensation and fixed compensation, more productive workers prefer variable pay (Dohmen and Falk, 2011). Friebel et. al (2017) state that when teams of employees receive both variable and fixed pay, the extra productivity of the workers receiving variable pay does not have an overall effect on team output. Therefore, organizations might consider this data when hiring workers or designing compensation plans. Deo (2011) offers this guidance: Workers whose productivity is above organization goals could be entitled to both variable and fixed compensation, while those who underperform targets receive only a fixed compensation. To summarize, although variable pay structures do not necessarily lead to increased productivity, more productive employees select variable compensation over base pay alone.

The final theme that emerges from the review involves workers' view of risk-taking relative to compensation plans. Dohmen and Falk (2011) point out that different incentive plans attract workers that have varying attitudes toward risk-taking. Friebel et. al (2017) observe that, in terms of effort, the marginal cost of effort is larger for older workers, and among teams that have older workers, the incentives lead to smaller effects on sales. The implication is that older workers might not be willing to take on additional risk to earn higher pay. Madhani (2010) suggests that less well-known firms and firms in the start-up phase of the business cycle should have a compensation structure in which variable pay is a larger proportion of overall pay. This compensation structure attracts more risk-tolerant individuals and rewards them for taking the financial risks associated with working for a less established firm. Boyer (2011) points out a potential risk of implementing a variable-pay incentive plan. Because it compensates people for bearing risk, these incentive plans ultimately can be very costly to organizations. In summary, the articles reviewed clearly indicate that individuals view risk-taking differently. Some individuals are less risk averse and might be willing to work for a start-up firm, while individuals that are approaching retirement might be less willing to take on the financial risks associated with less established firms that rely more on variable compensation plans. Organizations can use compensation structures to attract employees who can best help them to achieve their overall business objectives.

Table 4. Key findings and our translation of the collective findings

	Finding 1 (Time)	Finding 2 (Organizational Objective/ Culture)	Finding 3 (Productivity)	Finding 4 (Risk-Taking)
Study 1 **Boyer, M. (2011)**	Incentive payments must be made when the information on performance is obtained.	Incentive pay can help to ensure that the pursuit of individual objectives focuses on achieving the organization's goals and objectives.		Incentive plans are costly to run because of the need to compensate people to bear the risk.
Study 2 (Parts 1 and 2) **Deo, P. (2011)**	Incentives should emphasize both long-term performance (based on overall organizational goals), paid in the form of company shares, and short- term performance (based on individual business units), paid in the form of cash.	The incentive plan should include both fixed and variable components to motivate employee performance and to achieve planned objectives.	Fixed compensation can be used to pay employees who don't meet targets, while employees who exceed them can receive both fixed and variable pay.	Variable plans can be used to motivate employees to exceed targets; the firm pays elevated payouts for higher levels of performance; and the variable payout may increase at a higher rate after targets are met.
Study 3 **Dohmen and Falk (2011)**	Salespeople in fixed payment systems need more time to solve problems.	Changing the pay system can change the entire work environment and firm culture.	When choosing between the alternatives of variable and fixed payments, more productive workers systematically prefer the variable pay.	Different incentive schemes systematically attract individuals who have different attitudes, such as a willingness to take risks and a relatively higher self-assessment.
Study 4 **Friebel et al., (2017)**		Historically underperforming teams can be successfully motivated to perform better with the implementation of an incentive plan; however, high-performing teams would not be motivated to perform better.	In teams that are made up of both variable and fixed compensation workers, the extra effort of variable compensation workers has no effect on the overall team output.	Older workers may have larger marginal costs of effort, which translates into a prediction that when teams include older workers, the bonus leads to smaller effects on sales.
Study 5 **Madhani, P. (2014)**	Organizations characterized by a formalized, centralized, and structured workplace require a long-term, system-wide perspective; the heightened focus on coordination would require a larger focus on fixed pay.	When culture and pay mix are synchronized, the result is a synergy with which the culture acts as an asset and a competitive advantage.	Cultural differences exist between organizations where the emphasis is on variable pay and those where the emphasis is on base pay, and the people that succeed in the two cultures are different.	If the business objective is risk-taking, then the compensation strategy should have a higher proportion of variable pay opportunities.
Study 6 **Madhani, P. (2010)**	Relatively low fixed pay and too much variable pay, with an opportunity for earning large incentives, can cause salespeople to become short-sighted when it comes to employing their time and efforts.	Effective compensation strategies focus on providing a pay mix of enough fixed pay to attract the best sales employees and sufficient variable pay to motivate them.		Variable pay should increase as a percentage of total compensation when the firm is relatively less well known (e.g., at the start-up stage) among its customers.
Translation	Variable pay should be focused on achieving shorter term individual goals, while fixed pay is better suited for longer term organizational goals.	A combination of both variable pay and fixed pay offers the best opportunity to achieve desired performance results and to create the best firm culture.	Variable pay does not necessarily lead to increase productivity; however, more productive workers do select incentivized compensation over base pay alone.	Firm compensation structure can be used to attract specific characteristics in salespeople. Those who are motivated by an incentive structure are less risk averse.

CONCLUSION

Based on our review and interpretation of the articles' conclusions (noted in Table 4), variable pay structures offer some merit related to performance results in a sales-oriented organization. Organizations' compensation structure can be used to attract employees who have specific characteristics. Newly formed companies and less well-known companies in a particular market can use a more heavily focused variable compensation plan to attract salespeople who are less risk averse and who tend to be more productive. The variable portion of the compensation plan should be focused on the shorter-term goals at the individual level, while longer term organization goals are better suited for the fixed portion of the plan. Ideally, a combination of both variable and fixed pay offers the best opportunity to achieve the desired performance and culture that organizations want to achieve.

RECOMMENDATIONS

Based on the literature studied, organizations should consider factors at both the firm level and the employee level when designing or changing a compensation structure. Firm level considerations would include both the firm's stage in its life cycle and its culture. Considerations for employees would include demographic and personality characteristics, such as their willingness to take risks, age, career stage, and job function.

The research by Madhani (2010) offers insights into structuring compensation plans based on the life cycle of the organization. Specifically, start-up firms and firms in the decline stages should lean more heavily on variable compensation structures because the uncertainty is greater in these organizations. Madhani further indicates that firms in the growth and maturity stages typically are defined by higher cash flows and can afford to lean more on base pay structures. In terms of firm culture, Madhani (2014) points out that firms needing to adapt to changing market environments or wanting to heavily incentivize individual initiative would focus on variable pay structures. Firms in more predictable environments or needing to emphasize organizational goals over individual goals would focus on a fixed pay structure. Note that any changes in compensation structure can affect firm culture. As previously mentioned, Dohmen and Falk (2011) state that introducing variable pay in jobs that predominantly have had fixed pay structures could reduce job satisfaction among workers who are accustomed to the consistencies of the fixed pay structure.

Fixed and variable pay structures are likely to attract different types of workers. As previously discussed, start-up firms face greater risk than mature firms and are likely to attract more risk-tolerant employees. Research conducted by Dohmen and Falk (2011) found that workers who are more productive and more willing to take on risk also are more likely to prefer a variable compensation structure. The experiment conducted by Friebel et. al (2017) shows that bonus structures have a lesser effect on older workers. Therefore, highly productive risk-takers benefit from a variable compensation structure, and older workers tend to be less motivated by variable incentive plans. Firms also should consider the roles employees play. For example, in some cases, incentivizing risk-taking and paying employees to take on more risk has been shown to have negative consequences (Bloom and Milkovich, 1998).

Compensation decisions are complex and, as discussed, affect both firms and their employees. Ideally, organizations should use a compensation plan that includes both variable and fixed incentives. Variable incentives would focus on short-term individual objectives paid when objectives are met; fixed incentives are the base compensation and longer-term incentive packages.

LIMITATIONS AND FUTURE RESEARCH

Limitations of this study include the relatively small number of peer-reviewed papers we found that related to compensation structures. Although we used a broad, multi-step search strategy, as shown in Figure 1, to identify pertinent papers, the limited research presents challenges when trying to draw conclusions for practice. This paper offers a summary of key findings across the papers reviewed, it also reveals that opportunities are abundant for future research on compensation structures and for expanding the literature in this area.

Previous research has focused on organizational culture (Madhani, 2014), organizational life cycles (Madhani, 2010), principles of incentive pay (Boyer, 2011), and the design of compensation structures (Deo, 2011). To expand on the work of Madhani (2010), researchers might investigate the compensation structures of companies moving across the various stages of the organizational life cycle. For example, research could try to link compensation structures to organizations' length of time in a particular life cycle stage. Dohmen and Falk (2011) and Friebel et. al (2017) identify characteristics of individuals who might find fixed and variable incentive structures attractive. Many companies today use personality testing instruments (e.g., Myers-Briggs, DISC, and The Caliper Profile) prior to hiring sales professionals and other employees. Further research might link scores on common personality testing to success in variable or fixed compensation structures. In addition, for many companies, the shift to work from home during the pandemic has raised questions about whether compensation should shift for workers who would rather not return to the office. Research could seek to understand the effects of post-pandemic telecommuting work on organizations' compensation structures for pure remote workers, pure on-site workers, and workers using a hybrid approach.

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Kevin Chalk was born and raised in North Carolina. He obtained a Bachelor of Science in Finance from East Carolina University, a Master of Business Administration from Kennesaw State University, and a Doctor of Business Administration from Georgia State University. He also holds the Chartered Financial Analyst designation. For over 25 years his professional career has been in the financial services industry. He has held roles serving the financial needs of individual investors as well as teaching investor education classes. In 2006, he transitioned his career from serving individual investors to working as a Relationship Manager for the Registered Investment Advisor community. In this role, he helps independent investment advisors with practice management solutions to help them grow, compete, and succeed in the marketplace. His research interest focuses on helping investment advisors become more efficient with managing growth using fintech solutions. In addition to his career in the financial services industry, Kevin is pursuing his passion for teaching as an adjunct professor at the University of North Georgia.

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