Unintended Consequences of Incentives

Unfortunately the law of unintended consequences is alive and well in incentive schemes, but Stewart Forsyth and other specialists have discovered a pragmatic, research based solution to the problem.

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It is an article of faith for many that incentives are an important part of the successful management of people. A recent New Zealand review of best practice in the manufacturing sector established incentives as part of the HR gold standard – they were one of the criteria proposed for judging the effectiveness of businesses' human resource management.

Mixed Results

A review of HR practices 16 years ago reported that incentives produced mixed results. The 1997 Cranfield survey of HR practices in NZ businesses found no change – overall the use of incentives did not distinguish profitable companies from the rest (see 1).

However there is good news for those who dislike consultants who tell you, 'On one hand I think incentives would be good for your business, but on the other...'. Research by Watson Wyatt (see 2) provides an indication of the types of incentives that do seem to make a positive difference. Profit share bonuses seem to work, but only if they are based on the businesses' overall performance, and not the performance of individual units.

New Zealand research by James Guthrie found a similar result. It was the company or group based incentives that made a difference – contributing to lower staff turnover and higher productivity.

Simple Logic

What is it with business unit based bonuses? There is often strong pressure in organisations to use this approach. For managers this is an example of providing a clear link between performance and reward. If your team, group, department or whatever delivers the results, then the people who have contributed to that result get a share. If the unit doesn't perform – sorry, but no cigar.

But what seems a logical approach is actually an example of the law of unintended consequences – which is alive and well in the world of incentives.

Winners and Losers

Let's see what I mean by looking at a 2-by-2 table here (see 3). This illustrates, in terms of the performance of, and the later rewards for, individuals in the business units, what actually happens when businesses use unit based bonuses.

Remember there are people in these boxes. For the people in boxes B and D the contingencies are the logical ones – the ones that make a positive difference to performance:

- The Winners put in the effort, contributed to a great unit result, were rewarded and will be motivated to make a big contribution next year;
- For the Losers, natural justice is in operation – they will be motivated to try harder, or get the message that there might be a softer option elsewhere.

Passengers

I want you to think about the Passengers in box C:

- These are the ones who attract a lot of management attention;
- These loafers get a reward just for being in the right place at the right time.

The manager's agitation is easy to understand. Rewarding these people sends the message that the important thing is wangling the right assignment, that kissing up and getting on the winning team is more important than putting in the hard yards.

What message does that send to the people who actually do the hard work (mostly, but not exclusively, the managers)?

Plummeting Stars

But you want to look at the Plummeting Stars – the soon to be former A-team. These are effective people (and we all know how hard it is to find them these days), who just happened to be in the wrong unit at the wrong time. And got burned off. And where are they going now? This is a terrible waste, because:

- Even if they stay around they aren't going to be as productive next year;
- When motivated, these people are seriously productive.

In fact the risk of not rewarding the A people is more serious than the risk of inappropriately rewarding the C people (or the C and the D people) – but more about this soon.

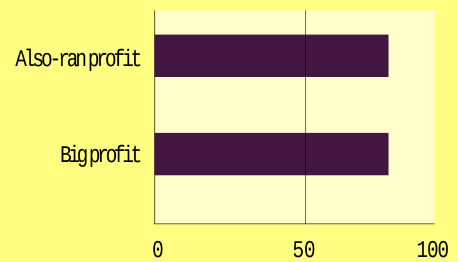
What often happens is that managers do see these downside issues of the unit based bonus system – usually in the last week of the year – and decide to sort it out. They lobby to have the C people excluded from the bonus pool. They find creative ways to get some rewards to the A people.

The unit based bonus system stays around, recognised as a blunt tool that needs a bit of refinement. Just how motivating it is becomes a little problematic.

Seal Of Approval

What is the answer? The pragmatic, and as we have seen already, now research based solution, is to have an across the business profit share.

Business Profit x Use of Performance Appraisal



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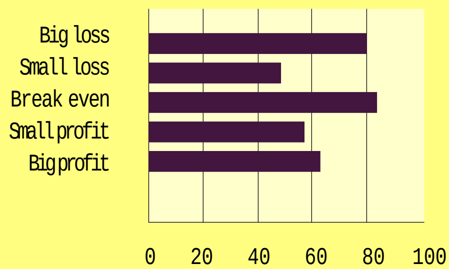
Business Profit Performance x Use of Individual Performance Related pay



This gets the Watson Wyatt seal of approval (and has been found to work in NZ businesses too.)

But while this is a clear, straightforward to implement, and motivating approach to incentives, it is not popular. The main reason for its low approval rating is the idea of paying those C and D people for their low performance. In fact the motivational research suggests that we are motivated more by the risk of losing than the opportunity to win. This seems to be the driver behind the vehement arguments of senior managers against 'losing' this bonus money.

The solution is simple. 'What are you doing about these under performing people?' It's all about performance management, not about rewarding passengers. Identified performance issues need to be addressed – and that is a better use of managers' time than trying to game the incentive system.

In practice, by combining an across the board profit share with a strong focus on managing performance we lift individual and organisational performance.

2. Incentives That Make A Difference

Financial incentives that contribute to improved business performance	Careful about these incentives
Staff eligible for stock option Top performers paid more than average performers Company positions pay above market Pay is linked to business strategy Employee performance appraisals used to set pay **Employees participate in a profit sharing plan based on firms overall success**	Employees participate in profit-sharing plan based on business unit success

Watson Wyatt Human Capital Index, 1999

3. Unit Based Bonuses

High Performance	A: Plummeting Stars	B: Winners
Low	D: Losers	C: Passengers
	No Reward	Reward

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