

THE PITFALLS OF PAY-FOR-PERFORMANCE

by Wim Van Der Stede

Pay-for-performance (PFP) is often seen as a virtually guaranteed means of achieving employee alignment and motivation and hence superior business performance. But, as Wim Van der Stede points out, PFP has its own potential pitfalls unless handled with care.

PFP is an incentive scheme in which employees receive extra, performance-dependent compensation for their work if they reach certain performance targets. The most common form of PFP incentive awards are cash bonuses. Nearly all firms above minimal size provide some form of PFP to some employees, at least to management level and above. But PFP schemes are also provided at nonmanagement levels and are becoming increasingly popular in the non-profit sector, such as healthcare, where personnel are being rewarded for meeting healthcare service delivery targets.

There are, of course, many benefits from PFP for both the business and the employee. The former gains, presumably, from improved employee alignment and motivation (more of this, later). But PFP also makes compensation more variable with business performance, allowing the business to pay higher compensation only when it can best afford it while reducing compensation expenses when performance is poor. The incentive payments are not entitlements and they are not annuities: they are one-time payments based on performance. Employees appreciate the extra cash, when they meet their performance goals. What's more, employees often feel that their efforts are rewarded more fairly as they are paid for performance rather than for 'pulse' (ie for just being there) or for seniority. Indeed, the primary rationale for pay-for-performance is to differentiate pay: to provide higher rewards for employees who make the largest contributions. By better recognising employee contributions, firms can more effectively encourage outstanding performance.

PFP - what is there not to like?

So what is there not to like about driving employees to work harder by offering them money for achieving certain performance targets? To answer this question, let us examine the key thrust of PFP: stimulus. Stimulus has two elements, namely:

1. informational - the PFP rewards attract employees' attention and inform or remind them of the importance of the rewarded performance. Merely telling employees that customer service, for example, is important might have some effect on their behaviours. But including customer service measures in annual bonus plans is more likely to convince them to emphasise customer service. The rewards signal the performance areas that are important and help employees decide how to direct their efforts. Because money is almost universally valued, monetary awards are highly effective in directing employees' attention; and
2. motivational - some employees need incentives to exert the extra effort required to perform tasks well: ie to work hard, do a good job, and succeed. Sometimes even hardworking employees need incentives to overcome their natural aversion to some difficult or tedious actions that are in their organisation's best interest, such as working cooperatively with other divisions to resolve customer complaints, making cold sales calls to get more business, preparing paperwork, or

training employees.

For the above two reasons, one of the most widely-held beliefs about human behaviour in organisations is that monetary incentives are the most powerful drivers of performance.

Distorted performance in multifaceted jobs

However, providing informational and motivational stimuli by connecting pay to performance may be trickier than it appears. This is so primarily because most jobs that employees perform in today's economy are multifaceted, consisting of many desired activities which compete for the job holder's time and attention. A good example of such multitasking, as this is often called, is delivering current performance at the same time as developing new business. In addition to the challenge of that dual goal there is a further complicating factor: delivering current performance is relatively easily measured in, say, accounting terms, whereas developing new business is much harder to define, less certain, slower to emerge and harder to measure by any readily-available performance measures, accounting or other.

Given that this measurement complication is likely to lead firms to emphasise the more-easily measurable task by including it in the incentive system, the result is that the PFP system is likely to induce the employees to focus a disproportionate amount of their attention to delivering current performance at the expense of, in this example, developing new business. This is, ironically, testimony that PFP works - employees respond to what is signalled by the incentive system as being important (the informational stimulus) and what they are rewarded for (the motivational stimulus). But it comes at the expense of devoting less attention to important-yet-under/unrewarded activities that are just as critical, sometimes even more critical, for success.

Weak incentives may be best

Therefore, when multitasking is desired – which arguably is the case for most jobs in today's developed economies – it may be best to provide relatively weak incentives for any of the desired dimensions of performance. Although this advice perhaps seems paradoxical, this is so because PFP systems that are not well-calibrated across all the important dimensions of a job will distort the effort allocation of employees because improving incentives for one task may worsen those for other tasks leading employees to overemphasise the better compensated activity and undersupply the other.

There is an abundance of examples illustrating this point, but consider the following one*. City officials wanted to tackle overtime in a garbage collection service. To motivate the garbage collectors to finish early, they were offered an incentive scheme where they would be paid full time even if they reported back early. And it worked! Garbage collectors came back consistently early and received full pay for the shift, which was apparently an attractive deal for them. But despite this good effect, there was also an increase in preventable traffic accidents, missed pickups of garbage, and trucks filled over the legal

weight limit. By emphasising time in the incentive scheme, time is what they got or, rather, rushed time - at the expense of safety, service, and obeying work rules.

I particularly like the above example because garbage collection is not exactly what comes to mind when thinking of multitasking, yet even this job is apparently complex enough to be subject to the effects of distorted incentives. Consider, then, the complexity involved in determining appropriate weights on the multiple dimensions of, say, managerial jobs, and one can see how easy it is for incentives to have potentially damaging effects. The punch line is that there are very few jobs, even apparently simple ones, where what is counted is all that counts.

Attracting the 'wrong sort'

Organisations not only turn to PFP systems to motivate employees who are already there, but also to attract talented employees of a desired profile. This is particularly so when businesses overtly offer compensation packages with belowaverage base salaries but with PFP compensation elements that provide the opportunity to earn above-average total compensation if excellent performance is forthcoming. These packages tend to appeal to employees who are entrepreneurial, rather than risk averse, and those who are confident about their abilities to produce superior results.

Initiatives to use compensation packages to attract and retain such employees often are seen as a key feature of a firm's recruitment strategy aimed at building a performance-driven culture.

While this is quite a reasonable strategy to pursue, it is not without its downsides. First, when incentives become increasingly leveraged - ie, when incentive pay becomes an increasingly important and larger part of employees' total compensation packages - the incentives are also more likely to have the distorting effects discussed above, especially when they are not carefully calibrated. Second, and related, when highly leveraged, it is not a stretch to see how quickly such compensation packages can turn a performance-driven culture into a money-driven one. This has two undesirable implications, of which businesses should be aware, namely:

- that those who come for the money are also likely to leave for the money (despite this being counter to the intended effect of PFP on employee retention); and
- that evidence suggests that PFP systems almost always lead to higher compensation.

Regarding the latter, to improve recruitment, businesses will have to offer compensation packages that are comparable, or even superior, to those offered by their competitors if they want to attract employees from the same labour pool. Thus, once introduced, PFP systems are likely to create a labour market that forces companies to follow suit in order to attract talent without necessarily the benefit of greater motivation and/or retention. It is easy to see, then, how PFP quickly becomes an institutionalised practice or business necessity rather than

a motivational tool aimed at promoting a performance-driven business culture.

THREE POINTS TO CONSIDER IN YOUR REWARD STRATEGY

- Incentive structure – badly structured incentives are more likely to have unintended consequences relative to weaker but possibly more complete incentives across all the important dimensions of an employee's job.
- Incentive intensity – some of the downsides of PFP systems are proportional to their intensity. More is not always better and good incentive effects can sometimes already be achieved at relatively low levels beyond which the (un)desired incentive effects may decrease (intensify) quickly.
- Money, money, money? Complement monetary incentives with various non-monetary rewards, which can have good effects and are often less costly to the firm, yet valued by employees.

'More' PFP is not always 'better'

How then to break free from these unintended consequences? After all, hardcore advocates of incentives could still claim that this shows that incentives work! I, too, believe that they work, but I do not believe that more is always better. As a matter of fact, some of the downsides of PFP systems seem to be proportional to their intensity. Whereas it is impossible to perfectly calibrate incentives in multitask settings, even presumably relatively simple ones, the negative side effects of illcalibration are exacerbated when incentive pay constitutes a larger part of total compensation. Interestingly, research** suggests that the positive effects of PFP might already be achieved with a relatively low incentive intensity, and that the motivational effects of PFP taper off quite quickly beyond a meaningful amount.

Moreover, although money clearly is a motivator for the vast majority of employees, it is by no means the only thing that people value. Other research*** has shown that firms tend to over-estimate their employees' concerns for financial rewards and under-estimate intrinsic job features, such as their desire to build a reputation; enjoy decision authority, perform meaningful work, and be appreciated. Not only can non-monetary rewards fulfil a potentially effective role as part of an incentive package, they also place a smaller financial burden on the firm.

Conclusion

When Warren Buffett recently started looking for a 'new Buffett' to help him run his investment empire, he reportedly said "job hoppers and money-grubbers need not apply". In so doing, Buffett highlighted the key point about PFP: that while money is an important motivator with potentially good effects on performance, when it becomes the sole or even just the predominant stimulus it is likely to backfire on businesses' ability to attract, motivate, and retain the talented employees for which PFP was designed.

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