Does incentive compensation incentivise the right behaviours?

In this series, Palladium asks expert strategy practitioners to share their experiences and opinions. We asked:

Many organisations use variable compensation to incentivise better performance. The underlying assumption – that people will work harder to earn more – sounds like common sense, and in many cases it works well. But is that all there is to it?

Incentive compensation also risks incentivising the wrong behaviours. If performance targets are the basis of compensation, why agree to stretch targets? If compensation plans are time-bound, why focus on long-term strategic initiatives that won't pay off until next year, or later? If performance is measured on the financial dimension alone, why invest in the non-financial drivers underpinning that performance?

So how can an organisation design incentive compensation systems to reward employees for executing the strategy without encouraging dysfunctional behaviours? Or is incentive compensation the answer at all?

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This poignant question shines a light on the dark side of incentive plans. Any incentive plan, no matter how well-intentioned, will have dysfunctional side-effects. These dysfunctions can cause companies to water down the implementation to the point that the incentive becomes more like a guaranteed bonus – in effect undermining the whole point of the scheme. Alternatively, companies may redesign the incentive schemes hoping to design away the dysfunctions. But more often than not a different design just creates different dysfunctions.

Should we abandon incentives? We can, but in effect 'no incentives' is just at one extreme of plan design, and as with all designs it comes with its own batch of headaches. Companies with the 'no incentive' design may discover employees are not clear about their goals, high performers are not rewarded differently from low performers, and employees are insufficiently motivated. When these dysfunctions arise companies typically lurch back towards implementing an incentive scheme.

So what's the solution? First we have to embrace the realisation that the problems that come with incentives can't be designed away. This is hard for technically savvy people to accept. We are used to feeling confident that given a puzzle we can find a clever, if complex, solution. With incentives that isn't true. While some designs are better than others, all of them, including the no incentive option, create problems.

If we can't solve the problem of incentives with clever design, then we need a new tactic. We find that tactic by looking at managers whose groups seem to be undamaged by the dysfunctions of the incentive scheme. What these managers do is actively intervene, day by day, to leverage what is good about the incentive plan and mitigate what is bad. If a scheme doesn't adequately distinguish between good and poor performers then the manager uses non-monetary rewards. If the scheme seems to promote bad behaviours the effective manager cracks down on them. The manager is in charge, not the incentive scheme.

The big takeaway is that you cannot replace good management with well-designed incentives. And here we come across the secret sin of incentives. Why do many people have such high hopes for incentive programs? It's because they hope it can compensate for weak management.

So the solution to the dysfunctions of incentives is to work on how we select, develop and train managers. We need to let incentives be simply one of the tools wielded by good managers who understand the downsides in any design and correct for them. Implicit in this conclusion is that managers need to have enough flexibility in how they administer the incentive program to counteract the dysfunctions that exist.

Re-designing incentives is appealing because it seems to be a quick fix for guiding and motivating employees. Improving the processes for selecting, developing and training managers is a long and difficult path. However, it is the long and difficult path that leads to success, whereas the seeming quick fix will just shift the problems around. Incentives can be a good tool, but don't lean on them too heavily; they only work if you've invested in developing skilled managers.

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In his 2010 *New York Times* best-selling book *Drive*, Daniel Pink ignited a heated debate that still smolders today within the world of total rewards. Pink presented scientific evidence suggesting that not only do many performance-based incentive programs (on which organisations spend billions annually) not work: some of them actually undermine the outcomes they intend to incentivise. Since the publication of Pink's book, several academic meta-analyses have verified Pink's conclusion that compensation-based incentive programs deliver mixed results when it comes to return on investment.

So how does one know whether investing thousands, or even millions, in a performance-based incentive program is worthwhile?

One of the core problems researchers have identified with incentive-based compensation is the influence of environmental variables (such as culture, management style, communication practices, etc.) that can impact the effectiveness of an incentive system. This is one reason why a "best-in-class" incentive scheme that appears to work at one organization has no apparent impact at another. To identify whether an incentive structure is IN FACT working at your organization, you need to measure outcomes.

The good news is that with the advent of digital technology and big data analytics, measuring the impact of incentive programs is easier than ever before. You don't need a team of data scientists and PhD statisticians to glean valuable insights about your performance-based incentive programs. A competent analytics professional with access to some key databases and readily available analytics software can deliver meaningful results.

A good example is an analysis performed by the team at Gap Inc. on an enterprise spot bonus program. A decade into the program, executives were curious whether the several million dollars spent annually on the program was delivering a return. To determine this, the Talent Analytics team used factor analysis and other analytics techniques to review eight years of data (ranging from retention to promotion to job performance) on award recipients. The results? On average over the 8-year period, award recipients were 31% more likely than non-recipients to be promoted, 42% more likely to receive a top performance rating, and 75% less likely to leave the organisation. Based on conservative turnover cost calculations alone, the ROI on the program was 23% or nearly a million dollars annually.

Given the high relative cost of many incentive schemes, the complexity of variables affecting human motivation in the workplace, and the increasing availability of cost-effective workforce analytics solutions, it makes sense to invest in incentive analytics. As Dan Pink and others have demonstrated, it's no longer prudent to merely rely on "common sense" or what worked for others ("best practice") when making a decision on incentive-based compensation. In the 21st century of advanced analytics, what gets measured gets results.

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As we work with clients around the world, we have seen a clear trend that even organisations who excel at executing their strategy struggle to link their strategy to individual employees. People have been talking about how to link the individuals in the workplace to the organisation's strategy for decades. In reality it has remained an elusive goal.

And yet, some organisations have got it right and reaped the rewards. Key to successfully linking strategy to incentives is understanding that incentives are more than just financial. Indeed, financial incentives were not, as is generally believed, originally a mechanism to motivate improved performance. As we moved into the industrial age, work moved from payments for tasks to fixed employment with wages. Organisations were looking for ways to move a part of a fixed cost to variable. Incentives, or bonuses, helped achieved this. Tying bonuses to the annual budget cemented this practice as a way of life – with all the dysfunctional behaviours it continues to engender. Along the way, the non-financial aspect of motivating performance got lost.

While financial incentives are critical (although more or less so depending on the job and the culture), attracting and retaining high performers requires a more sophisticated approach. High performers at all levels of an organisation want to contribute to the future success of the company, and they also want the company to contribute to their own future success. These kinds of incentives can come in many forms, through a comprehensive development process, non-financial recognition, or building a strong sense of meaning with the organisation.

We are seeing a generational change in which younger people view the incentives they receive as much about how they develop their own sense of personal development, self-worth and contribution to worthwhile goals (so the mission of the organisation) as it about how much extra they receive in their paycheque (although still important). Moreover, research has shown that more conventional non-financial rewards (such as simply publicly acknowledging great performance) can be much more powerful and more cost-effective in securing employee engagement than cash. Organisations need to think of all three elements, financial and conventional non-financial rewards, as well as individual developmental requirements, when shaping incentive systems that drive heightened performance.

Once you have a robust incentive system, however that looks, it is essential that you then tie it to the execution of strategy. Drs Kaplan and Norton recognised this in their Strategy Focused Organisation principles. Incentive systems reward behaviours.

Through the use of personal scorecards that clearly link the individual to the organisation's strategy, organisations can effectively link performance rewards to successful execution. Translating an organisation's strategy to the individual level gives each individual a clear understanding of how they contribute to the success of the organisation and how the organisation contributes to them personally. By incentivising those personal scorecards, an organisation not only increases its chances of successfully executing it strategy, it also goes a long way towards building the meaning in the workplace that high-performing employees crave.

Incentives are clearly a key element of organisational success, but by understanding that incentives need not always be financial and the need to align incentives to the strategy, organisations set in place the building blocks for organisational success.

How organisations shape financial and non-financial incentive systems is contextual and extremely cultural. There is not, and will never be, a one-size-fits-all approach. They secret sauce is understanding what the organisation wants to achieve and what the individual seeks in their own career and personal development and building personal scorecards that delivers both. Not easy, but if achieved the results for the organisation will be astonishing.

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