Our Love-Hate Relationship with Monetary Incentives

Depending heavily on monetary incentives to motivate people is nothing short of dangerous, especially for a firm whose mission is to maximize shareholder value. Dean Roger Martin explains.

Roger Martin

Take a cursory look around at today's business environment, and you'll find we have a complicated relationship with monetary incentives. All the way from the CEO's suite to the shop floor, we love that they motivate employees to do whatever is necessary to carry out an organization's mission. But we also hate that they cause those same employees to engage in extreme and unproductive activities, such as manipulating financial results or abusing customers in order to maximize their incentive compensation.

Like most motivational tools, monetary incentives have limitations and produce differing levels of utility in different contexts. To produce more beneficial results for their stakeholders and society at large, firms must lower their expectations of monetary incentives and be more cognizant about setting them within a context that reduces the tendency for extremes of behaviour.

The love-hate rationale

One of the reasons we love monetary incentives is that we have seen them drive individual behaviour time and time again, and drive it powerfully. When **Coca-Cola Co.** provided **Robert Goizueta** with the most lucrative monetary incentive package in the history of public corporations, he retired a very rich man, with approximately $700 million to his name. But happily for Coke's shareholders, that amount seemed minuscule in comparison to the mammoth increase in Coca-Cola's value during Goizueta's 16-year reign. From the time he was named CEO in March of 1981 until his death in 1997, Coke's stock rose an amazing 3,800 per cent, making the 'Goizueta years' the stuff of corporate legend.

We also love monetary incentives when we see them as instrumental in building and repairing society. After the massive 1994 earthquake in Northridge, California – which caused $40 billion of damage – construction teams rebuilt roads and bridges in a fraction of the time predicted, thanks to completion-time incentives that motivated them to work 24 hours a day rather than the usual 9 to 5 'punch-clock' approach.

But we hate monetary incentives when we see them drive individual and collective behaviour – from the very top to the bottom of firms – that is profoundly counterproductive and embarrassing.

In 1989, at its eponymous Auto Centres, **Sears** introduced a monetary incentive system that based compensation on the average revenue per customer visit. Employees took the incentive to heart, proceeding to convince customers that unnecessary services were in fact vital to their car's performance. Revenue-per-customer rose dramatically, but the behaviour it engendered resulted in a huge public scandal. A 1999 class-action lawsuit claimed Sears had defrauded its customers nationwide of $400 million, with up to 30 million people affected between 1989 and

1994. Just this past March, the company was charged again. This time, New Jersey's Attorney General filed suit against Sears for overcharging thousands of customers at its car-repair centers across the state.

Closer to home is the ongoing scandal at **Nortel Networks.** In the post-bubble crash, mired in years of losses and mammoth write-offs, the Nortel board put into place a powerful monetary incentive for its leaders to achieve coveted break-even status. If Nortel could achieve break-even for one quarter, it would be worth US$13.6 million in incentive compensation for the management team, with another $30 million on offer for achieving three consecutive quarters of profitable operation. This program allegedly drove senior management to massively under-report income in 2002 in order to make sure that 2003 was a break-even year. In July of 2003, Nortel management received its bonuses in cash and stock: since-deposed CEO **Frank Dunn's** take was $2.15-million, while **Douglas Beatty,** the sacked CFO, got $831,000.

Nortel's performance crashed in early 2004, and thankfully for the shareholders that alerted the board to investigate, the CEO and CFO were subsequently fired for cause. As the company moves forward, only one thing is certain: Nortel has been forever changed. Its remarkable turnaround since 2002 proved to be exaggerated, if not completely bogus, and shareholder confidence has been shattered.

In case any doubt remains, there is ample scientific evidence that monetary incentives have a powerful impact on individual behaviour. Perhaps the most striking study of their effects was performed by **Donald Roy** and published in the *American Journal of Sociology* in 1952. As a young PhD student, Roy demonstrated his dedication to his research by working in a machine shop for ten months in order to collect data on the effect of piece-work pay schedules on performance. He found the work of his fellow machine operators to be powerfully influenced by the prevailing incentive compensation structure. And perhaps most shocking to himself – a PhD student, not an elementary school educated labourer – his own work patterns began to model those of his co-workers under the incentive compensation structure (see sidebar).

Donald Roy: Quota Restriction and Goldbricking in a Machine Shop

(*American Journal of Sociology*, 1952)

Donald Roy's machine shop was a classic piece-work shop of its day. Its machine-tool operators fabricated a wide variety of items at their stations, with each assigned a point value based on management's assessment of the level of difficulty required to produce the item, as assessed by engineers from the 'timing department'. If an operator turned in 125 points in an hour, he (all were male) would earn $1.25 for that hour of work. The company provided the operators with base pay of $0.85 per hour, such that if the points they turned in were lower than 85, they would still earn the minimum amount. For anything over 85 points per hour, the direct monetary incentive was that one more point generated one more cent in hourly compensation.

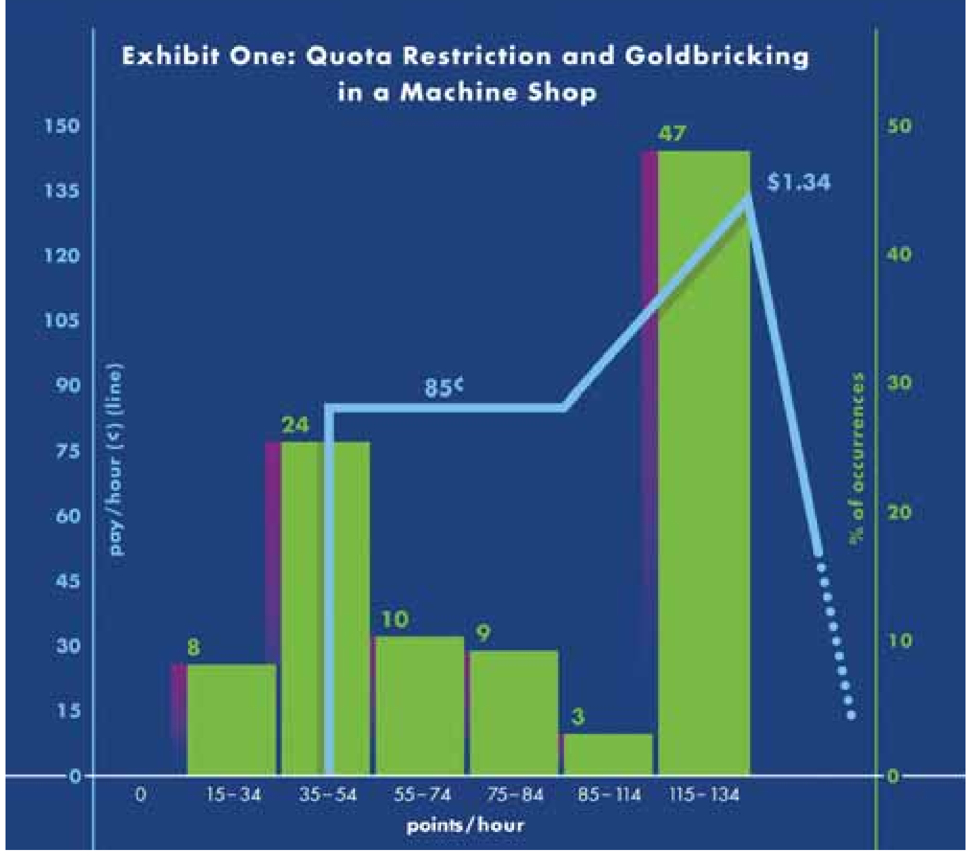
Roy observed that the incentives embedded in the compensation structure generated behaviours that at first seemed quite odd. The largest fraction of work turned in (47 per cent of total hours) was for point totals between 115 and 134. The second largest fraction (24 per cent) was between 35 and 54 points. Every other range had tiny proportions of the total hours (see Exhibit One).

What caused these two high-frequency ranges at such odd levels? It turns out that amongst the workers, jobs associated with these ranges were referred to as 'gravy' and 'stinker', respectively. 'Stinker jobs' were so difficult – i.e. their point totals were too low in relation to the work required – that the operator declared defeat immediately and slacked off – or 'goldbricked' to use the vernacular. But why not goldbrick entirely, not turn in 35 to 54 points? As Roy found out, any operator who turned in less than 35 to 54 points in an hour risked being fired for incompetence. So the extreme of goldbricking was in the range of 35-54 points per hour, which netted the basic $0.85 compensation.

In contrast, 'gravy jobs' were so easy in relation to their point values that the minimum could be reached with only a modicum of effort. But why stop at accumulating 134 points per hour? Roy found out – by himself hitting 150 on a gravy job and being accosted by angry co-workers – that whenever a job yielded more than about 134 points per hour, the timing department would descend on the shop and lower – often dramatically – the point value for the job. So while the monetary incentive to keep working until accumulating 134 points was high, the monetary disincentive to go even a point past 134 was even higher. As a result, the operators engaged in 'quota restriction', by which they would work at an artificially slow pace or loaf for hours at a time to restrict themselves from turning in a point total over the informal maximum.

Exhibit One (page 7) overlays the true compensation structure – including threat of termination below 35 points per hour and threatened re-timing above 134 points per hour – on the distribution of work to demonstrate the power of monetary incentives to drive behaviour patterns that appear inexplicable at first blush.

Roy estimated that goldbricking and quota restriction – which, within a month of joining the shop, he engaged in as dutifully as his co-workers – caused the machine shop to work at approximately half of its potential productivity, all a direct function of the structure of the monetary incentives.



Despite the clear evidence of the power of monetary incentives on individual behaviour, the evidence of influence on firm performance is quite mixed. In "Do Incentives Work? The Perception of A Worldwide Sample of Senior Executives" (*Human Resource Planning* 26, no. 3, 2003) **Michael Beer** and **Nancy Katz** review the findings on incentive compensation and come to the conclusion that they are "ambiguous". Some studies find significant positive effects of compensation structures with strong monetary incentives – pay for performance like Coca-Cola and Roy's machine shop – while others find no obvious positive effect. And as the Sears, Nortel and Roy's machine shop examples illustrate, monetary incentives can have decidedly negative effects on firm performance.

The Problem with Monetary Incentives

Ironically, the problem is that monetary incentives work – too dramatically. Just as animal trainers can use the right set of incentives to get lions to jump through flaming hoops or elephants to walk on their hind legs, monetary incentives can get workers to engage in 'unnatural' behaviours. Indeed, in the right environment, they can produce almost any behaviour. And as Roy's machine shop shows, monetary incentives often drive behaviour to extremes. 'Stinker' jobs don't produce work effort in the $0.60 range, and 'gravy' jobs don't produce work effort in the $1.00 range: stinker jobs produce work on the margin of dismissal, and gravy jobs on the margin of re-timing.

The power to drive individuals to extremes of behaviour is largely responsible for our love-hate relationship with monetary incentives and the ambiguity as to their effectiveness at the firm level. The truth is that it is enormously challenging to design a monetary incentive system that is in any degree balanced.

For example, stock brokerage firms have been challenged by a widespread reputation for their brokers 'churning' the portfolios of their clients in order to generate commissions. This should come as no great surprise in that until recently, compensation for brokers tended to be paid strictly on the basis of commissions: for every dollar of commission revenue generated for their firm, brokers earned a fixed percentage (ranging as high as 60 per cent) as incentive compensation.

This compensation structure is inclined to push individual brokers to the extreme of generating as much trading as possible up to the point where a client will 'pull the plug' because he or she views the broker as trading for the broker's own benefit, not theirs. In essence, the broker's welfare is maximized, rather than the client's. The result has been the rise of the self-directed brokerage and a response by brokerage firms to move toward non-commission-based compensation structures in order to deal with client perceptions of portfolio-churning.

The rise of shareholder value maximization as the primary mission of corporations has created a context that exacerbates extreme reactions to monetary incentive compensation.

The Importance of Context

Incentive compensation sends a very powerful message to employees. It screams from the rooftops: "We want you to do more of X, and if you do, we will give you more money as a reward." Ignoring the incentive offered is the moral equivalent of ignoring the wishes of the firm – and would be seen as a form of insubordination. In this respect, the context of the firm, whether Roy's machine shop in 1952 or Nortel Networks post-2000, plays an important role in producing or ameliorating the tendency toward extremism in response to the incentive.

One has only to read between the lines of Roy's description of the machine shop to draw conclusions as to the key features of the problematic context in question. The overall impression is of a firm that is little-loved by its machine operators. Operators appear to have no customer contact and no particular knowledge as to what happens to a part once it leaves their workstation. They appear highly distrustful of their employer, who swoops in to re-time jobs whenever the output seems too easy to achieve. They treat the firm as simply a money-making operation for the owners, whereby more money is made for the owners by reducing the money made by operators – a classic capitalist-worker class struggle. With no purpose to compete with or leaven the drive for personal money-making, the operators move to the extremes of goldbricking and quota restriction. In fact, their only motivation is solidarity with one another against the firm – something Roy learned as he began adhering to the group norms.

In the post-bubble Nortel context, with the company's stock price having fallen to one-hundredth of its bubble high, the obsession was with stock market performance: reassuring the stock market by returning to profitability became an end unto itself. It was translated into a singular goal – 'break-even or bust'. Nothing else mattered, and the monetary incentives were organized strictly around this singular goal. As a result, other goals faded into the background – goals related to innovation, customer satisfaction, and sustainable performance, amongst others.

In a way, there was perfect alignment at Nortel: the corporate goal was to break-even, and management's incentive was to break-even. One dollar short of break-even meant nothing, while the next dollar meant $14 million in incentive compensation. The result was extreme behaviour to produce break-even status – even at the cost of alleged major accounting fraud.

The rise of shareholder value maximization as the stated primary mission of corporations has created a context that exacerbates extreme employee reaction to monetary incentive compensation structures, and it has been accompanied by the rise of the importance of incentive compensation as a share of total compensation. Ironically, the rise of a tool – monetary incentive compensation – that has a design weakness (the tendency to produce extreme behaviours) has been driven by the rise of a context – where the firm's mission is shareholder value maximization – that exacerbates the very weakness in the tool of choice.

Toward More Love and Less Hate

So, are monetary incentives and shareholder value maximization inherently bad? No. They are just a volatile combination – sort of like **Richard Burton** and **Elizabeth Taylor**. And they are most volatile in combination when they are employed in a singular fashion: that is, when the corporation indicates that the only thing that matters is shareholder value maximization, and the only incentive for performance is monetary compensation.

> A firm where customer satisfaction is the central goal provides a more suitable context for monetary incentives.

This combination is self-defeating because customers – whose satisfaction is critical to long-term shareholder value maximization – come to understand quite clearly where they stand in the pecking order: a long way down the line. Employees spend their time maximizing their own incentive compensation, subject to keeping customers minimally satisfied, and the firm spends its time maximizing its returns, subject to the same constraint. Little, if anything, in the context encourages the true delight of customers.

As the great 20th Century philosophers **John Lennon** and **Paul McCartney** wrote, "Money can't buy me love." And money, in the form of incentive compensation in a shareholder value-driven firm, can't buy 'love' for the customers. In this context, the objects of maximization are personal compensation and firm value enhancement. In contrast, there is no motivation to maximize customer love. Rather it is simply a minimum constraint; as long as the firm and its employees don't treat the customer too badly, they will remain customers.

A firm where customer satisfaction is the central goal provides a more suitable context for monetary incentives. If the firm believes that serving its customers brilliantly is its primary goal and that shareholder value appreciation will naturally follow, incentive compensation geared toward encouraging superior customer service or customer-oriented innovation has a better chance of not producing extremes of personal monetary-maximization behaviour.

In such a context, the pride and happiness that comes from serving customers well comprises an important part of the 'psychic compensation' of employees. This is particularly the case if social stature within the firm is related more to satisfying customers than to earning higher compensation.

This competition of goals within a firm can serve to effectively replace extremism in pursuit of personal economic goals with the pursuit of a broader set of goals, which includes 'loving' one's customers. Monetary incentives are not ignored by any means, but non-monetary incentives – the feeling of pride in contributing to an organization's goal of offering the best product or service to its customers – compete closely. In essence, if a firm is more than simply a money-making machine, its employees can more easily see their roles as being more than personal money-making machines.

While there can be no arguing that the power of monetary incentives is great, their effectiveness in producing the desired end is entirely more speculative – and hence our prevailing love-hate relationship with them.

In the end, depending heavily (or gasp, entirely) on monetary incentives is nothing short of dangerous, especially for a firm that has as its mission to maximize shareholder value. When it comes to incentives, balancing them and dulling their 'sharp edges' with a supportive firm context is far preferable – for employees, the firm and for society – to unleashing them on their own. We've already seen abundant proof of what happens when they are left to their own devices.