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The Problem with Financial Incentives — and What to Do About It

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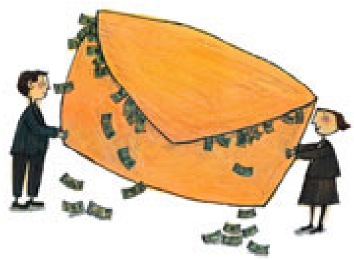

Bonuses and stock options often improve performance. But they can also lead to unethical behavior, fuel turnover and foster envy and discontent. In this opinion piece, Wharton management professors Adam Grant and Jitendra Singh argue that it is time to cut back on money as a chief motivational force in business. Instead, they say, employers should pay greater attention to intrinsic motivation. That means designing jobs that provide opportunities to make choices, develop skills, do work that matters and build meaningful interpersonal connections.

Enron. Tyco. WorldCom. The financial crisis. As corporate scandals and ethical fiascoes shatter the American economy, it is time to take a step back and reflect. What do these disasters have in common? We believe that excessive reliance on financial incentives is a key culprit.

Starting in the mid to late 1970s and 1980s, the view emerged in management thinking that the primary role of corporate leadership was to maximize the interests of shareholders. In time, this view came to be known as *financialization,* and *maximizing shareholder value* became the reigning mantra. Over time, the belief became almost axiomatic; questioning it was tantamount to heresy in many schools of thought.

This broader perspective translated at lower levels of organizations into an emphasis on rewarding employees with financial incentives contingent upon performance. The thinking seemed to be: Get the incentives right, and people will be motivated to perform better, resulting in better performance for the firm. Researchers Brian Hall of Harvard Business School and Kevin Murphy of the University of Southern California found that less than 10% of total executive compensation at publicly held firms was contingent on stock prices in the early 1990s, but by 2003 that share had ballooned to almost 70%. And despite the bad press and public uproar that big payouts generated in the wake of the financial crisis — when critics pointed out that many top executives had been heavily rewarded for short-term performances that ultimately proved disastrous — the system marches on. CEO bonuses at 50 big U.S. companies rose more than 30% last year, a gain not seen since before the recession, *The Wall Street Journal* reported in mid-March.

To be clear, we are not suggesting that companies abandon financial incentives. Indeed, there is a wealth of evidence that these incentives can motivate higher levels of performance and productivity. To assess results across multiple studies, researchers have used a technique called meta-analysis. As Sara Rynes of the University of Iowa and her colleagues summarize, on average, individual financial incentives increase employee performance and productivity by 42% to 49%.

But these gains come at a cost. Our concern is about the unintended consequences of financial incentives. What do they mean for unethical behavior, jealousy and turnover, and intrinsic interest in the work? And what measures can be taken to lessen their negative impact?

Three Important Risks

Several years ago, Green Giant, a unit of General Mills, had a problem at one of its plants: Frozen peas were being packaged with insect parts. Hoping to improve product quality and cleanliness, managers designed an incentive scheme in which employees received a bonus for finding insect parts. Employees responded by bringing insect parts from home, planting them in frozen pea packages and then "finding" them to earn the bonus.

This is a relatively benign example, but it points to a serious problem. Incentives can enhance performance, but they don't guarantee that employees will earn them by following the most moral or ethical paths. Research by Wharton management professor Maurice Schweitzer and colleagues demonstrates that when people are rewarded for goal achievement, they are more likely to engage in unethical behavior, such as cheating by overstating their performance. This is especially likely when employees fall just short of their goals. Harvard Business

School's Michael Jensen has gone so far as to propose that cheating to earn bonuses — such as by shipping unfinished products or cooking the books to exceed analysts' expectations — has become the norm at many companies.

When strong financial incentives are in place, many employees will cross ethical boundaries to earn them, convincing themselves that the ends justify the means. When we value a reward, we often choose the shortest, easiest path to attaining it — and then persuade ourselves that we did no wrong. This tendency to rationalize our own behavior is so pervasive that psychologists Carol Tavris and Elliot Aronson recently published a book called *Mistakes Were Made* (*but not by* me*)* to explain how we justify harmful decisions and unethical acts.

In addition to encouraging bad behavior, financial incentives carry the cost of creating pay inequality, which can fuel turnover and harm performance. When financial rewards are based on performance, managers and employees doing the same jobs receive different levels of compensation. Numerous studies have shown that people judge the fairness of their pay not in absolute terms, but rather in terms of how it compares with the pay earned by peers. As a result, pay inequality can lead to frustration, jealousy, envy, disappointment and resentment. This is because compensation does not only enable us to support ourselves and our families; it is also a signal of our value and status in an organization. At Google in 2004, Larry Page and Sergey Brin created Founders' Awards to give multimillion-dollar stock grants to employees who made major contributions. The goal was to attract, reward and retain key employees, but blogger Greg Linden reports that the grants "backfired because those who didn't get them felt overlooked."

This claim is supported by rigorous evidence. Notre Dame's Matt Bloom has shown that companies with higher pay inequality suffer from greater manager and employee turnover. He also finds that major league baseball teams with larger gaps between the highest-paid and lowest-paid players lose more games; they score fewer runs and let in more runs than teams with more compressed pay distributions. The benefits to the high performers are seemingly outweighed by the costs to the low performers, who apparently feel unfairly treated and reduce their effort as a result.

Similarly, Phyllis Siegel at Rutgers and Donald Hambrick at Penn State have shown that high-technology firms with greater pay inequality in their top management teams have lower average market-to-book value and shareholder returns. The researchers explain: "Although a pay scheme that rewards individuals based on their respective values to the firm does not seem unhealthy on the surface, it can potentially generate negative effects on collaboration, as executives engage in invidious comparisons with each other."

Other studies have shown that executives are more likely to leave companies with high pay inequality. The bottom line here is that financial incentives, by definition, create inequalities in pay that often undermine performance, collaboration and retention.

A third risk of financial incentives lies in reducing intrinsic motivation. In the 1970s, Stanford's Mark Lepper and colleagues designed a study in which participants were invited to play games for fun. The researchers then began providing rewards for success. When they took away the rewards, participants stopped playing. What started as a fun game became work when performance was rewarded. This is known as the overjustification effect: Our intrinsic interest in a task can be overshadowed by a strong incentive, which convinces us that we are working for the incentive. Numerous studies spearheaded by University of Rochester psychologists Edward Deci and Richard Ryan have shown that rewards often undermine our intrinsic motivation to work on interesting, challenging tasks — especially when they are announced in advance or delivered in a controlling manner.

Autonomy, Mastery and Purpose

So, the good results generated by financial incentives need to be weighed against the bad: encouraging unethical behavior; creating pay inequality that reduces performance and increases turnover; and decreasing intrinsic interest in the work. To limit the negative effects, we recommend that financial incentives should be (a) used primarily for tasks that are uninteresting to most employees, (b) delivered in small sizes so that they do not undermine intrinsic motivation and (c) supplemented with major initiatives to support intrinsic motivation.

Stanford's Chip Heath has shown that managers tend to have a strong bias in favor of extrinsic incentives: They rely too heavily on financial rewards, underestimating the importance of intrinsic motivation. In *Drive: The Surprising Truth About What Motivates Us*, Daniel Pink summarizes a rich body of evidence that intrinsic motivation is often supported by three key factors: autonomy, mastery and purpose. High effort and performance often result from designing jobs to provide freedom of choice, the chance to develop one's skills and expertise and the opportunity to do work that matters. Evidence also supports the importance of a fourth factor: a sense of connection with other people.

Autonomy involves freedom of choice in what to do, when to do it, where to do it and how to do it. Extensive research has shown that when individuals and teams are given autonomy, they experience greater responsibility for their work, invest more time and energy in it, develop more efficient and innovative processes for completing it and ultimately produce higher quality and quantity. For example, in a study at a printing company, Michigan State's

Fred Morgeson and colleagues found that when teams lacked clear feedback and information systems, giving them autonomy led them to expend more effort, use more skills and spend more time solving problems. Numerous other studies have shown that allowing employees to exercise choices about goals, tasks, work schedules and work methods can increase their motivation and performance.

Mastery involves the chance to develop specialized knowledge, skills and expertise. Research shows that when employees are given opportunities for mastery, they naturally pursue opportunities to learn and contribute. For instance, research by the University of Sheffield's Toby Wall and colleagues documented the benefits of giving operators of manufacturing equipment the chance to develop the skills to repair machines, rather than waiting for engineers, programmers and supervisors to fix them. The operators took advantage of this opportunity for mastery to create strategies for reducing machine downtime, and worked to learn how to prevent problems in the future. As a result, they were able to complete repairs more quickly and reduce the overall number of repairs.

Purpose involves the experience of contributing to a meaningful effort or cause. Adam Grant (one of the authors of this piece) has shown that when employees meet even a single client, customer or end user who benefits from their work, they gain a clearer understanding of the purpose of their jobs, which motivates them to work harder and smarter. For example, when university fundraisers met a single scholarship student who benefited from the money that they raised, the number of calls they made per hour more than doubled and their weekly revenue jumped by 500%. And when radiologists saw a photo of the patient whose X-ray they were evaluating, they felt more empathy, worked harder and achieved greater diagnostic accuracy. In *The India Way*, Wharton management professors Peter Cappelli, Harbir Singh, Jitendra Singh (one author of this piece) and Michael Useem observe that Indian companies have found success in motivating employees by cultivating a strong sense of purpose and mission. As Adam Smith, the father of economics, wrote in *A Theory of Moral Sentiments*: "How selfish soever man may be supposed there are evidently some principles in his nature which interest him in the fortunes of others, and render their happiness necessary to him, although he derives nothing from it except the pleasure of seeing it."

Connection involves a sense of community, belongingness and being valued by others. Although financial incentives can support connection for star performers, they often impede it for the rest of the organization by creating pay inequality. Studies consistently show that the strongest driver of turnover is not pay, but rather the quality of an employee's relationships with supervisors, co-workers and customers. In a meta-analysis led by Rodger Griffeth of Georgia State University, the quality of relationships with their direct bosses explained more than twice as much variance in employees' decisions to quit as did their objective pay levels or satisfaction with their pay. Even a small but genuine gesture of thanks can help employees feel valued. In a study conducted with Francesca Gino of Harvard Business School, Adam Grant found that the effort of call center employees increased by 51% during the week after an external manager paid them a single visit to express appreciation for their work. In short, relationships matter for retention and motivation.

Finding the Right Context

Researchers Amy Mickel of California State University, Sacramento, and Lisa Barron of the University of California, Irvine, have argued that managers should think more carefully about the symbolic power of financial incentives: who distributes them, why they are distributed, where they are distributed and to whom they are distributed.

When incentives are given by high-status leaders, employees may see them as more meaningful. For example, blogger Greg Linden notes that "Google rarely gives Founders' Awards now, preferring to dole out smaller executive awards, often augmented by in-person visits by Page and Brin." When incentives are awarded in public, they confer greater status but also make inequality more salient. Carefully designing financial incentive programs to carry symbolic meaning can be an important route to enhancing their effectiveness and reducing their adverse consequences.

So what does the overall picture look like? We believe that financial incentives have an important role to play in employee motivation, but the reality of human motivation is more complex than the simpler vision built into the financialization model. Excessive reliance on financial incentives can lead to unintended consequences that sometimes defeat the very goals they are designed to achieve. We feel that it is also important, for instance, to create cultural contexts that help shape norms, values and beliefs specifying guidelines for inappropriate actions, regardless of financial incentives.

Perhaps such an approach would have saved the school board members in Kenosha, Wis., from losing a large chunk of their teachers' retirement plan in risky investments called Collateralized Debt Obligations (CDOs). These investments should never have been sold to them. Although the financial incentives for all the actors in the decision chain were well aligned, what was apparently missing was the necessary ethical restraint.
