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# Linking goals to monetary incentives

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Every experienced executive knows the importance of rewarding good performance and also how difficult it is to design an incentive system that works as it is supposed to. A recent article in the *Wall Street Journal*[1] reported that Hewitt Associates found that 83 per cent of companies with a pay-for-performance system said that their incentive plan was "only somewhat successful or not working at all."

Consider just some of the ideas that must be addressed in designing an incentive system:

- What should be the form of the incentive plan? That is, how, specifically, should pay be tied to performance?
- How do you keep employees from short-cutting or cheating in order to get their bonus?
- Which actions or outcomes should you pay bonuses for?
- What will be the effect of incentives on actions or outcomes that are not included in the incentive plan?
- How many different actions or outcomes can an employee actually manage?
- If more than one action or outcome is part of the plan, how should they all be combined or weighted?
- What do you do when market conditions change radically and make the incentive system ineffective or meaningless?

It is no accident that most companies constantly tinker with, and often radically overhaul, their incentive plans. Many can never seem to get it quite right. This article will try to provide some answers to the above questions, but I will start by addressing one fundamental issue. Hewitt's research indicates that one major cause of the failure of incentive plans is the lack of clear goals.

Goal-setting theory, as summarized by Gary Latham in the previous article, asserts that people must have goals that are both clear and challenging in order to motivate high performance. The question then arises: How do you combine goal setting with incentives?

I will describe four different methods and the pros and cons of each.

### Method 1: Stretch Goals with Bonuses for Success

This method involves assigning people difficult or stretch goals, giving them a substantial bonus if they reach them and no bonus if they do not. The respective advantages and disadvantages of this method include the following:

*Pros.* This method provides a strong incentive to attain the goals. There is a huge difference in reward between attaining the goals and failing, even by a small amount, to attain the goals. Further, it leaves no ambiguity about what is required of the person to receive the bonus.

*Cons.* A weakness of this method is ironically the result of its strength. Precisely because the motivation for goal attainment is so high, there is considerable temptation for the person to think short range, e.g., pile up excess inventory with customers (which will come back to haunt the company in the next quarter), take short cuts (e.g., lower quality, ignore maintenance, increase risk), and cheat (e.g., exaggerate or make up totally fake results, cook the books) in order to receive the bonus.

To prevent these and other dysfunctional outcomes, the organization needs rules of conduct: ethical norms or standards that are clearly communicated and consistently enforced. The moral atmosphere or climate of an organization is set by the CEO and the senior management team, who must not only be impeccable role models but who must make certain that the company's ethical standards are strictly enforced (e.g., those who flout them must be fired). If the CEO and top managers are not personally honest, it leads to demoralization and cynicism among employees. This, in turn, can lead to a whole culture of dishonesty.

Another downside of this method is that performance which is very high but just misses the goal yields no bonus at all. This can be very demoralizing to competent, hard-working employees. It can lay the seeds for future dishonesty.

### Method 2: Multiple Goal Levels with Multiple Bonus Levels

This method avoids some of the problems of method 1. Instead of a single goal level with the bonus being "all or none," there are multiple goal levels (for example, five), and a different bonus level is attached to each—the higher the goal level attained, the higher the reward.

*Pros*. There is less temptation for employees to short cut or cheat here, because even if they do not attain the top goal level, they can get a bonus for making the next lower level. Highly competent employees who just miss a high-level goal still get rewarded.

*Cons*. Because there are multiple goal and bonus levels, employees may be less motivated to try for the highest level than in the case of method 1. A problem can occur if employees are content to try for the lowest goal level that is rewarded. For this bonus system to be effective, the CEO or senior management must set some minimum goal below which performance is considered inadequate. Then the multiple-goal level can start from a level above this minimum. However, this approach still does not push everyone to try for the highest goal. Furthermore, there is no tangible motivation to exceed the top goal because no further bonus would be forthcoming. Of course, pride and recognition are powerful motivators independent of money, but most employees want consistency between tangible and intangible rewards.

### Method 3: A Linear System

This method is recommended by Michael Jensen of the Harvard Business School.[2] It is a variation on method 2, which involves increments. Consider five levels of sales goals, e.g., +5%, +10%, +15%, +20%, +25%. The employee who makes 24.5% will get rewarded, but only for reaching the 20% goal, so may still feel disappointed at coming close to, but just missing, the 25% goal. The simplest solution here is to make this a continuous bonus system, e.g., a 2% bonus for every 1% increase in sales. (Obviously 1% is still an increment but a very small one).

*Pros*. This method eliminates two disadvantages of methods 1 and 2. First, there is no "loss" for getting close to a higher goal level and just missing it; an employee gets paid for exactly what is achieved. This, according to Jensen, further decreases the temptation to cheat or take shortcuts. Second, there is no upper limit on the bonus. Under methods 1 and 2 if a person attained the top goal for an increase in sales (say 25%), the employee would get the same bonus even if that person achieved a +50% or +100% sales increase. So there would be little tangible incentive to exceed +25%. Under method 3, however, if the person gets a 50% sales increase, the bonus would be 2 × 50% or 100%.

*Cons*. There is still the problem inherent in method 2: less pressure for the employee to "stretch." Setting a minimum goal would help as with method 2, but many people might not be financially motivated to go far beyond the minimum. Also some companies could have a problem with unlimited compensation for employees; it might seem unfair to people in other parts of the company (e.g., non-sales jobs) where a meaningful linear system would be hard to design.

### Method 4: Motivate by Goals but Pay for Performance

This method, suggested by Gary Latham of the Rotman Business School (University of Toronto), makes the tie between goals and performance a little looser than under the other methods. The employee is given specific, challenging goals, but the decision about bonus awards is made after the fact so as to take account of the full context in which the goal is pursued. The relevant context factors might include: e.g., how much was actually achieved regardless of what the goals were, how the company as a whole did, how difficult the goals *really* were, in the light of such factors as resources, obstacles, and market conditions, as well as the methods the employee used to attain the goals (e.g., ethical behavior). Often the bonus decisions will be made by a management team because they may have more knowledge than any one executive.

*Pros*. The main benefit of this method is its flexibility and comprehensiveness. For example, an employee who tries for a hard goal under very difficult circumstances but does not quite reach it can still be well rewarded, whereas an employee who attains an allegedly hard goal which turned out not to be so hard in hindsight would get less (or be penalized or fired if the goal was attained unethically). This method, of course, is similar to what is called "merit based pay," but it would require that clear goals be set for every action or outcome that was important to the organization.

*Cons*. This method requires the boss to be knowledgeable about the full context and also to be objective in order to minimize favoritism or bias.

Many people at the CEO and top-management levels lack these qualities. Of course, with poor quality leadership, the other incentive plans may not work either, because no method is better than the people who use it.

### Which Method Is Best?

To the author's knowledge, there have been no published field studies or laboratory experiments comparing the effectiveness of the four systems described above or even comparing any two of them. Thus there is no basis for claiming that one is necessarily better than others. Much may depend on the nature of the business and the quality of the management. This topic is ripe for further study and experimentation.

Observe, from the Kerr and Landauer article, that GE decided to make a distinction between goals that were absolutely essential to the organization and goals that were not. Stretch goals, which allowed credit for failure, were used mainly in the latter case. This implies that different incentive rules could be applied to each type of goal.

Cheating or short-cutting can occur under any incentive system; thus, as noted earlier, all companies need a strict (and enforced) code of ethics and well-designed control systems. (GE was known for having excellent control systems).

### What Activities Should Goals Be Set For?

For whatever is important. This will certainly involve performance outcomes and often goal-setting for the critical actions that lead to those outcomes. For example, sales, specifically repeat sales, depend on customer satisfaction, and there are specific actions that can be taken to satisfy customers (e.g., on-time delivery, high-quality products, changing policies as a result of customer feedback, etc.). Customer satisfaction is a "soft" measure, yet it can be measured quantitatively. Information-sharing with other managers, executives, employees, and so forth is another desirable action that often can benefit the entire company. Information-sharing could be measured by means of peer assessments. Developing subordinates is another important activity required for long-term organizational success.

It is possible to make causal maps that show the relationship between behaviors and outcomes. Consider this example: knowledge sharing within the company and with customers→improved customer service and better products→improved customer satisfaction→improved customer retention and sales→increase in profits. Note that goals can be set for any part or all parts of this sequence. Observe also that the benefit of the causal map is that it forces one to formulate the plan for improving the final outcome: profits. The causal inputs constitute a plan.

Actions and outcomes for which goals are not set and which are not rewarded monetarily will probably get minimum attention unless they are causally connected to the actions and outcomes that are measured and rewarded. A poorly devised bonus system can create "tunnel vision"—a focus only on what gets rewarded to the neglect of other important outcomes. Of course, bonus systems are *supposed* to focus attention and effort in a certain direction to the exclusion of others. Thus it is critical to do a lot of thinking about which actions and outcomes are important before creating a goal and reward system.

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### How Many Goals Should There Be?

It is important to avoid cognitive overload. No one manager, for example, could make good progress toward achieving 17 different goals, unless most of them could be delegated, nor would the manager even have the time to track progress. One person alone could probably handle somewhere between three and seven goals, depending on how difficult and complex they were and how much time was allowed for completion.

If employees are trying to achieve multiple goals, this presents a problem with respect to designing the reward system. *Ideal reward systems are simple*, and the simplest system has only one rewarded outcome or goal. The problem is that a one-goal system is usually too narrow in scope for a job. When a one-goal system is not adequate, there is an advantage to method 4, since it can take account of as many goals as the boss or top-management team considers relevant. If methods 1, 2, or 3 are used with multiple goals, then the goals have to be weighted in terms of importance.

### Goal Integration

In any organization virtually everything that happens affects everything else, for better or for worse. Ideally, goals should be integrated across the entire organization, but this is usually impossible due to time constraints. However, through knowledge sharing within and across organizational levels and departments, it is possible to coordinate essential activities (e.g., sales, marketing, and production all need to be involved if a new product is contemplated). Such coordination is what cross-functional teams are designed to achieve.

Goal integration, including knowledge sharing, may be facilitated if part of the bonus is paid on the basis of peer ratings of knowledge sharing and/or on how well the company as a whole does.

### Should Goals Be Changed When Conditions Change?

If goals are changed constantly (e.g., every three months), the danger is that no one will take them seriously. But if the strategic direction of a company changes, the goals need to reflect such changes. For example, when Jack Welch decided that GE would embrace the Six Sigma quality-control process, every executive was given goals to train employees in Six Sigma principles and to initiate Six Sigma projects. Bonuses were based, in part, on performance in relation to those goals.

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What if the economy or industry turns bad? At Nucor, plant workers get paid by team productivity. If steel demand goes down, they get paid less. The same principle holds for Nucor's plant managers and executives. In some years profits drop, and no bonuses are distributed. Nucor's philosophy is: Why should plant employees and executives get bonuses when the stockholders are losing money? At Nucor they have to tough it out until business increases. A business downturn could be a signal to develop better business strategies, to cut costs, and to set new goals.

### The Effective Incentive System

Effective bonus plans are extraordinarily difficult to set up and to maintain. It has been said that it is better to have no bonus system at all, other than simply merit pay, than to have a bad one. Bad incentive plans encourage people to do the wrong things in the wrong way, and they lead to cynicism, anger, and indifference. The first step that should be taken when considering setting up a bonus system is to ask: What do we really want people to do or accomplish? As Steve Kerr, a former GE executive, said many years ago, there is no point in rewarding A if what you want is B.[3] This issue probably takes more thought than any other aspect of an incentive system.

The second step is to set goals for desired outcomes. Make them clear and challenging. If needed, include goals for the actions that lead to the desired outcomes and not just the outcomes themselves. Make sure the number of goals assigned is doable. And do not change the goals too readily.

The third step is to consider which goals will need to be integrated within and across levels and divisions.

The fourth step is to pick the type of bonus system that is right for your company considering what you came up with in the first three steps, with full awareness of all the pros and cons of each method.

Following these steps will not guarantee that you will devise a successful bonus system, but it will definitely increase the odds.

### Endnotes

[1] Chu, K. Firms report lackluster results from pay-for-performance plans. *Wall Street Journal,* 15 June 2004: D-1.

[2] Jensen, M. 2002. Paying people to lie: The truth about the budgeting process. Harvard Business School Working Paper 01-072.

[3] Kerr, S. 1995. On the folly of rewarding A, while hoping for B. *Academy of Management Executive,* 9(1): 7–14.

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