Variable pay-for-performance is a folly

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Abstract: As the bonus culture in the financial sector once again comes under attack, this column challenges the typical defence that banks need to pay top dollar to attract the best talent.

VOX
7 August 2011

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Scientific literature has extensively dealt with variable pay-for-performance (see e.g. Frey and Osterloh 2002). Despite the fact that serious problems linked to this approach have thus become obvious, many authors continue to support compensation according to predetermined performance criteria because they are committed to the traditional concept of the „homo oeconomicus“.
Overall, there has been a marked change of opinion in academia. The idea that people are solely self-interested and materially orientated has been thrown over board by leading scholars. Empirical, in particular experimental research has shown that under suitable conditions human beings care for the well-being of other persons. Above all, they are not solely interested in material gains. Recognition by co-workers is greatly important. Many workers are intrinsically motivated, i.e. perform work for its own sake because it is found challenging and worth undertaking. This applies not only to qualified employees but also to persons fulfilling simple tasks. They often are proud of their work and performance.
There are four major arguments against variable pay-for-performance:

(1) In a modern economy, it is practically impossible to determine tasks that are to be fulfilled in the future precisely enough so that variable pay-for-performance can be applied. In a society continually faced with new challenges, superiors oftentimes find it impossible to fix ex ante what an employee will have to do in the future.
(2) It would be naïve to assume that the persons subjected to variable pay-for-performance would accept the respective criteria in a passive way and fulfill their work accordingly. Rather, they spend much energy and time trying to manipulate these criteria in their favour. This is facilitated by the fact that employees often know the specific features of their work better than their superiors. The wage explosions observable in many sectors of the economy can at least partly be attributed to such manipulations, e.g. when managers are able to contract easily achievable performance goals.
(3) Variable pay-for-performance results in employees restricting their work to those areas covered by the performance criteria. In the literature, this is known as the “multiple tasking” problem. This may induce employees to spend considerable time and energy during their work trying to find a better paid job with another firm. They therefore neglect their tasks insofar as they are not contractually fixed by the performance criteria.
(4) Variable pay-for-performance tends to crowd out intrinsic work motivation and therewith the joy of fulfilling a particular task. However, such motivation is of great importance in a modern economy because it supports innovation and helps to fulfill tasks going beyond the ordinary.

Many observers acknowledge these problems connected with variable pay-for-performance and even emphasize them. They nevertheless cling to this form of compensation because they do not see any alternative. However, there are well-proven and effective ways to induce the members of an organization to perform in a desired manner. The three most important ways are the following.
The employees have to be *carefully selected*. Above all, it has to be checked whether the job seekers are interested in the work to be performed or solely in the money that will come along with it. In all too many sectors of the economy this task seems to have been neglected. In the financial sector, for example, many persons have been chosen whose only goal is to get as high a salary as possible. They therefore exhibit no loyalty to the firm and immediately accept any job that offers higher

compensation. As a result, the fluctuation among employees has increased strongly. Efficiency has been reduced because the tasks have to be taken over by ever new persons who lack the experience necessary.
Secondly, employees have to be paid a *fixed* compensation corresponding to their performance. They must be given the signal that they are paid a good wage but that they are expected to work accordingly. Thus, a market wage has to be paid in order to be able to win and keep employees. The compensation can after some time be adjusted on the basis of a *comprehensive evaluation of their work*. This procedure avoids the multiple tasking problem. At the end of the year, one can also distribute part of the profit to employees according to their contribution to overall performance rather than according to ex ante criteria.
Thirdly, *awards* can be used to enhance employees' work motivation. Awards such as "Employee of the Month" support social recognition among the members of the firm. They should therefore be presented in a festive ceremony, emphasizing what type of performance is important to the firm. Research on awards in a call center of a credit card company suggests that the motivation of the persons getting the award is enhanced. The performance of the employees not getting an award is not reduced. Rather, they make an effort to get the award in the future (Neckermann, Cueni and Frey 2008). Employees working in a team are usually proud that (at least) one of its members has received an award.

Variable pay-for-performance is an attractive concept to compensate employees only at first sight. It turns out to be a mistake when analyzed more thoroughly. As argued here, there are more favourable alternatives available.

Literature

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A version in German is forthcoming in *Oekonomenstimme,* 2011.