Incentive systems

- *an evaluation of the "Motivational Model for Rewards"*

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3. THEORETICAL FRAMEWORK

This chapter aims to create theoretical understanding about the scope of the study. We first present normative theories about incentive systems followed by the corresponding for theories of motivation. Finally we present a selection of studies conducted on the subject.

3.1 INCENTIVE SYSTEMS

3.1.1 BACKGROUND

Organizations exist to achieve some kind of objectives, which can be stated in financial or non financial terms. When evaluating how an organization's management controls functions there are a couple of questions that are important to address according to Merchant and van der Steede (2008). "Do our employees understand what is expected of them?", "Will they work consistently hard to do what is expected of them?" and "Are they capable of doing a good job?" Employees might not know how to maximize their contributions to the organization, and even if they know how, motivational problems may occur due to the fact that personal objectives and the organization's objectives do not match. Personal limitations in intelligence and knowledge are further examples of reasons why management control might fail (Merchant and van der Steede 2008).

Regardless of what type of objective organizations have, it is of utmost importance for the management to ensure that employees do their best to contribute to achieve the organization's objectives. One way of doing this is to use incentive systems. If it is done well, an incentive system informs the employees what results areas are desired and motivates them to achieve and exceed the performance targets (Merchant and van der Steede 2008). Individuals are more motivated by the chance of a reward than the fear of punishment. This suggests that incentive systems should be reward-oriented. (Anthony and Govindarajan 2003)

According to Merchant and van der Steede (2008), there are a couple of critical factors for a successful incentive system. The rewards must be valued, rewards without value for the individual do not provide motivation. Size of rewards must be large enough to affect employees' behaviour, too little a valued reward will also fail to give motivation. Employees should also understand why a reward is given and the intrinsic value. Rewards given short after performance have a stronger effect than those given a long time after. Therefore they should be given as soon as possible. A reward should be reversible so that mistakes can be corrected (Merchant and van der Steede 2008).

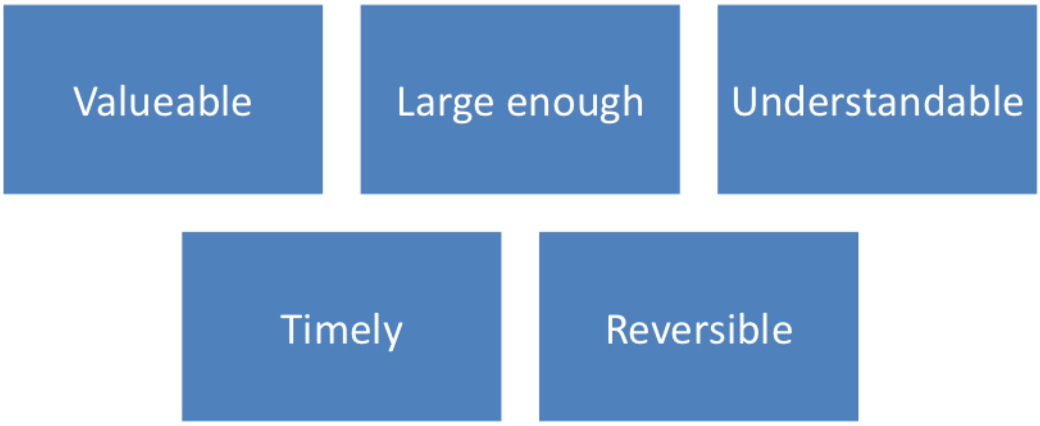

Figure 3.1 Critical factors for a successful incentive system

Source: Merchant and van der Stede (2008)

3.1.2 AIM OF INCENTIVE SYSTEMS

Three important aims of incentive systems are stated by Arvidsson (2004): Management control, motivating employees to desired performance and recruiting and keeping employees. Since employees' objectives often differ from the organization's objectives, the purpose of management control is to secure that there is goal congruence between the employee's personal goals and the organization's goals (Merchant and van der Steede 2008). At the same time, management control aims at high productivity and high efficiency in the organization's activities.

To motivate the employees is the second aim of incentive systems according to Arvidsson (2004) and that is partly achieved when employees value the reward that is given when the desired result has been achieved. Svensson and Wilhelmsson (1988) think that the wage is one part of the incentive system but since it is an obvious effect of work it might not be as important as other types of incentives. Employees expect to receive a wage, and therefore it is not as important when it comes to raising motivation apart from the size of it. Since different individuals respond to different incentives one key factor is to select a reward that is an incentive for as many individuals as possible. The third aim of incentive systems according to Arvidsson (2004) is to recruit and keep employees. He thinks it is sometimes necessary for an organization to offer staff rewards in order to be an attractive employer on the labor market and in the line of business.

The image below shows the conflicts that exist between the organization's objectives, an employee's individual objectives and the performance measurement. A well-designed incentive system affects the individual's performance to better align with the organization's objectives and the performance measurement.

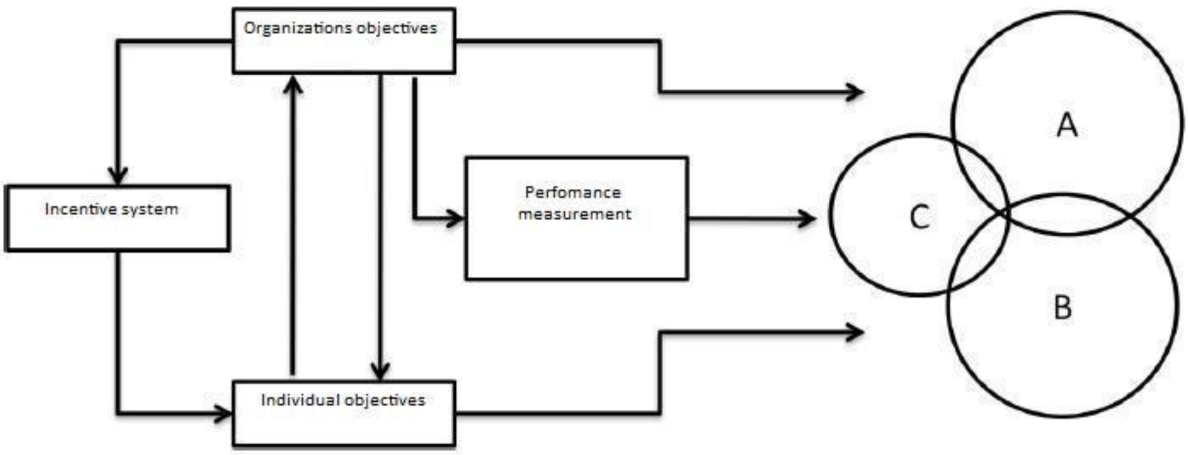

Figure 3.2 Management control for goal congruence

A = Desired performance to reach organizations objectives
B = Individual performance
C = Performance measurement

Source: Arvidsson (2004)

3.1.3 POSSIBLE FORMS OF INCENTIVE SYSTEMS

Rewards can be given on either individual or group level and variations in the methods used can be found between different cultures. Traditionally, Anglo-Saxon literature focuses on individual performance and more seldom on group-based performance. Since a large part of management literature originates in the Anglo-Saxon culture, group-based rewards tend to be devalued. Individual rewards may affect group-oriented behavior since employees may focus on being rewarded themselves. At the same time group rewards may result in lower motivation and less understanding of one's contribution because a person's own performance and group performance may differ. A term that is commonly used when discussing this problem is "free rider". This means an individual who receives a group reward even though the individual performance is below reward level (Arvidsson 2005). Group rewards can on the other hand encourage teamwork and make employees monitor each other's behavior, a type of positive peer pressure (Merchant and van der Steede 2008).

3.1.4 MONETARY REWARDS

A reward can come in many forms, both monetary and non-monetary. Monetary rewards are very common, especially at higher organizational levels. Three types are normally used. A salary increase is partly related to an increased cost of living, and the remaining part is provided for increased performance either now or in the future. An increase in salary is usually 2-3% above inflation but has a large effect over time due to the annuity that is yielded by salaries being raised year after year. Short-term incentives such as bonuses based on performance during one year or less are another type of monetary incentive. It has the advantage for the organization that the costs of incentives become variable with the overall performance, which is positive. Long-term incentives are measured over longer periods of time and usually aim to keep important talents and encourage them to become partners by giving for example stock options which give them the right to buy shares at a predetermined price (Merchant and van der Steede 2008).

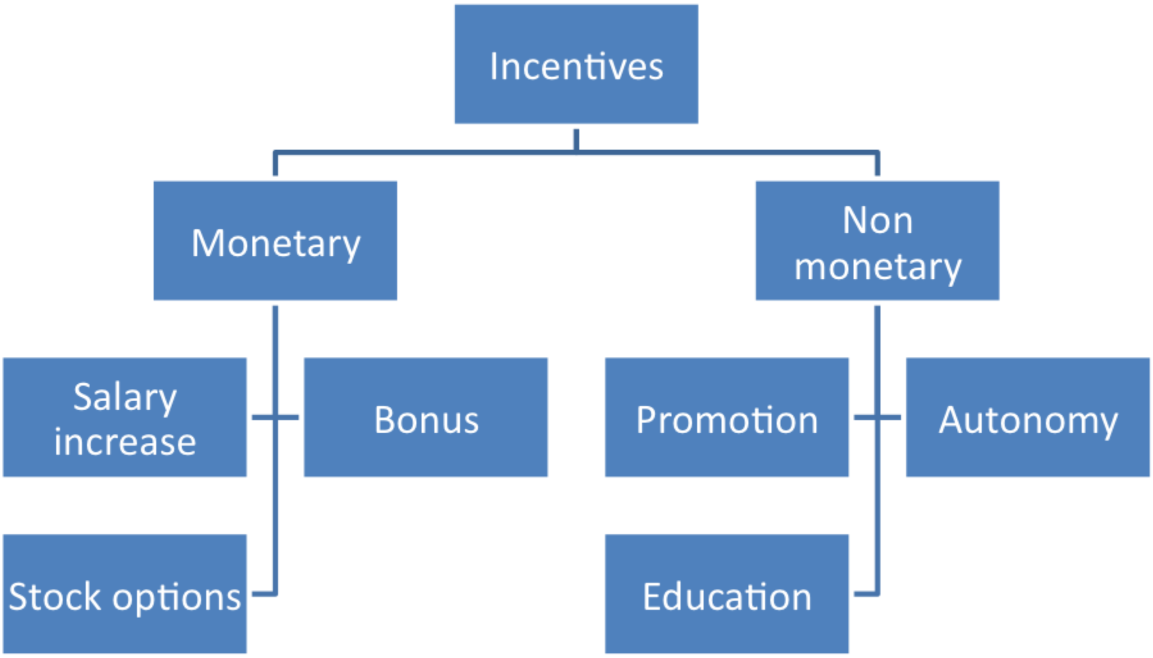

Figure 3.3 Different types of incentives

Source: Merchant and van der Stede (2008)

Almost everyone values money since it can be used to buy whatever one wants and also has a symbolic value of reflecting achievement and success. It may not, however, meet some important criteria according to Merchant and van der Steede (2008). Monetary rewards are sometimes based on judgment from superiors, which can lead to a lower understanding of why a reward is given. Since the time period for most monetary rewards are annual due to the budgetary process it can lead to rewards being given too late after performance for the employees to feel the connection between the two. If rewards are given for longer time periods than one year, the connection between performance and reward will be even smaller. It is also questioned if monetary rewards are lasting over time. A diploma for "Employee of the month" may stay on the desk for years but a bonus is spent on bills or random consumption (Merchant and van der Steede 2008).

According to Anthony and Govindarajan (2003), it is suitable for monetary rewards to have upper and lower levels, even though this may have side effects. They should exist so that, for example, a reward does not challenge the defined structure of salaries within the organization where the chief executive is at the top with highest salary. Unpredicted events with a large positive effect on an employee's bonus should also have a limited impact. A lower level secures that mediocre performance is not rewarded. On the other hand, an upper level might take away motivation to keep working hard if the maximum reward has already been attained (Anthony and Govindarajan 2003).

3.1.5 NON MONETARY REWARDS

Non-monetary rewards are a good complement to monetary rewards, and usually cost less. Even though money is an incentive for many people, it is far from the only thing that has any value as a reward. Non-monetary rewards are often greatly valued by employees and might even provide higher motivation. Giving an employee greater autonomy and recognition sends a clear message that the employee is going in the right direction and deserves a reward. Further examples of this type of reward are promotions and education (Merchant and van der Steede 2008).

3.1.6 MEASURES

Traditionally, incentive systems based on financial measures have been the most common type. Mainly return on equity, return on capital employed or different profit measures have been used (Arvidsson 2004). To base incentives on financial measures has the advantage of using numbers already existing in the firm's accounting, which makes the method easy and inexpensive, but on the other hand it has to be taken into account that accounting values are regulated and often differ from real values (Merchant and van der Steede 2008). Arvidsson (2004) states that to solely rely on financial measures is a method that has been criticized during many years. The main criticism has been that there is a tendency for financial measures to encourage short-term actions, which damages the long-term performance of the organization.

Ax, Johansson and Kullvén (2005) also think that financial measures have too much focus on events in the past and that they include too much information to enable interpreting. Complementing the financial measures with non-financial measures is often carried out to handle this problem. Arvidsson (2004) thinks that by doing so, an organization can focus on other areas such as customer satisfaction, markets shares and employee satisfaction, which has become more important for corporations. An empirical study of a hotel chain by Banker, Potter and Srinivasan (2000) proved that customer satisfaction was just as effective as a complex measure in predicting financial performance.

Organizations have searched for solutions to help them balance between short- and long-term incentives and this has led to three different strategies. First, stock options have been given as a reward to senior management. The purpose has been to encourage managers to make decisions which will serve the shareholders well. Bonus points for good performance have also been collected in a type of "bank" which the employee can collect over a longer period of time. Last, but not least, a combination of measures has been gathered in a balanced score card the aim of which is to help organizations combine financial and non-financial measures and at the same time keep focus in their key activities (Arvidsson 2005).

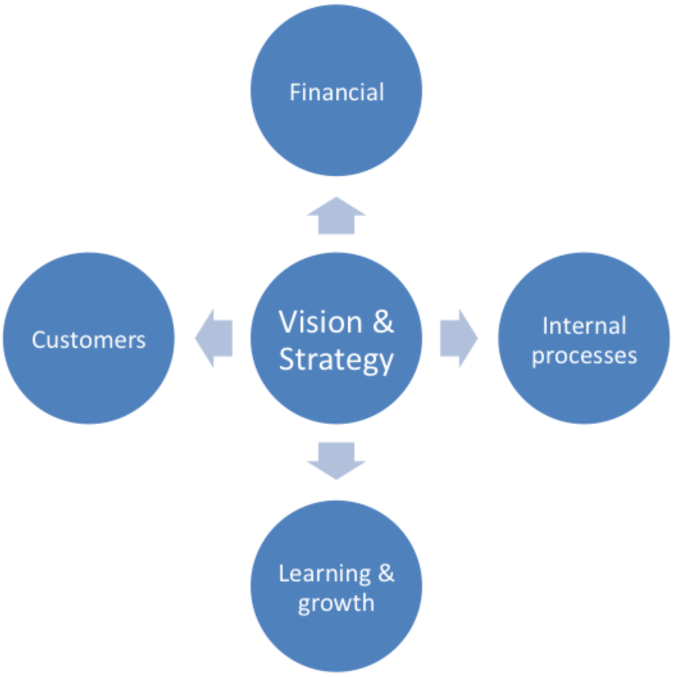

Figure 3.4 Example of a balanced score card

Source: Olve and Petri (2004)

A well-composed incentive system can fail if the performance targets are not set at proper levels; targets have to be both challenging and realistic. If set too low, the motivational effect will be low since rewards are given even though employees do not have to put in any significant effort. The level of motivation increases the harder the targets are set, but up to a certain level. If set too high, over the employees' limit of ability, motivation falls very quickly. Employees will end up discouraged, lose commitment to achieve the target and will put less effort in their work. Just how high targets can be set depends on maturity, experience and self-assurance of the people in focus. Many authors suggest that targets with less than 50% chance of success are suitable (Merchant and van der Steede 2008).

An individual or group as subjects for an incentive system must have the power to affect the performance. The person who is responsible must have the authority to engage actions in order to achieve goals. If a reward is given on parts of performance where employees feel he/she has no power to affect the outcome, there is a great risk that the reward does not provide the desired motivational effect (Arvidsson 2005).

3.1.7 UNCONTROLLABLE FACTORS

Uncontrollable factors that affect a business are divided into three categories: economic and competitive, acts of nature and interdependencies. The first category affects profit since it is affected by many factors that change continuously, for example consumer demand, goods/service prices and factor costs for doing business. Depending on how much the manager can influence, he/she can adapt the operation through changing purchasing, staff planning and marketing to better suit the new conditions (Merchant and van der Steede 2008).

Acts of nature are, for example, extreme weather conditions, deaths of key employees, fires and accidents not caused by negligence. Events damaging one company through a warehouse that has been burned to the ground can on the other hand benefit for example construction companies. One way of minimizing the damage from acts of nature can be to ensure that good insurance protection exists for the company. Interdependence exists when one organizational unit shares some kind of resource with other units or receives input from them. It can also exist when senior management does not approve lower level managers' decisions (Merchant and van der Steede 2008).

3.1.8 DIFFERENT TYPES OF INCENTIVES

Svensson and Wilhelmsson (1988) think that there are five types of incentives: restraint, physical, incorporated, social and internal. They further think that different incentives encourage individual performance and others promote co-operation. The construction of an incentive system needs to balance between the two in order to reach mutual goals. Too much focus on individual performance might lead to conflict and miss benefits of coordination. On the other hand, there is a risk that too much focus on collective performance leads to employees' competence not being used in an appropriate way.

Restraint is described as a negative incentive which leads to resistance and submission from persons being subjected. It does not fulfill the purpose of an incentive when used to encourage initiative, interest, care or responsibility. Once restraint has been used, only more restraint will lead to obedience. The true physical incentive according to Svensson and Wilhelmsson (1988) is salary based on performance. Physical incentives are most important to employees at low and middle level and can be related to relative amount of salary and social background of the employee. Money itself is also a symbol, which makes it a non-monetary incentive that can represent power and status. As the amount of money increases, the importance of the non-monetary incentives becomes more apparent.

Norms, values and ideals within a group or incorporated in a person as morals is also a powerful incentive. When doing something that does not follow our own or a group's morals we will suffer from feelings of guilt. Social incentives consist of involvement and identification. A person will do the tasks that lead to a positive reaction from the group no matter the task. Only the reaction from the group is important. "Employee of the month" awards are a social incentive with two goals. The publicity is a reward for the winners, but at the same time it creates an incentive for the fellow-workers to earn their own prize (Svensson and Wilhelmsson 1988).