Be careful what you pay for—you might get it.

Sins of Commission

By Jeffrey Pfeffer

On a sunny Sunday afternoon, my wife Kathleen and I went to Putnam Toyota in Burlingame, Calif., to test-drive a Camry. When we told the salesman that we were deciding between the Camry and a couple of other cars and would probably not make a purchase that afternoon, he sent us down the block to the place where the Camrys were kept, essentially blowing us off so he could wait on the next customer. This man, like most car salespeople, was paid by commission—encouraged to "move metal" and given no reward for building dealer loyalty. He did, in other words, just what he was being paid to do—and that did not include wasting time on people who weren't going to immediately purchase a car. Needless to say, when we finally decided to buy a Camry, it wasn't from Putnam but instead from Toyota of in Redwood City, which doesn't pay its salespeople on commission and instead has tried to build a customer-service culture and encourage dealer loyalty.

Or consider another example of an incentive system gone awry. A few years ago, the city of Albuquerque, N.M., faced a problem with its garbage collection. The truck crews weren't completing their assigned routes on time, landing the city with a huge bill for overtime pay. Believing in the power of financial incentives, the city hit upon a plan: Pay the drivers for eight hours regardless of how long it actually took them to complete their routes, figuring that this strategy would highly motivate the crews to finish their tasks quickly.

When I have used this example and asked audiences to guess what the drivers did, most have no trouble coming up with what actually happened. First, drivers found that they could finish faster if they didn't bother to pick up all the garbage on
their routes. Unfortunately, however, people whose pick-ups were missed would call the city, which would then have to send a truck to pick up their garbage, not a very cost-effective process. Second, drivers could finish their routes more quickly if they sped. But speeding causes accidents, and the city soon found itself paying out more money in accident claims. And third, the garbage-collection teams could cut some time if they didn’t go to the dump to drop off their loads as frequently; but this decision led to them driving the trucks over the legal weight limit and receiving fines when they arrived at the dump. In 2002, fifteen of the twenty-four drivers with the highest incentive pay brought overweight trucks to the landfill most often. All of these added expenses wound up costing the city dearly, according to a grand jury that looked into why Albuquerque’s apparent solution to its garbage-collection cost problem—implementing incentive pay—wound up being more rather than less expensive.

It may seem odd for me to complain about the use of individual incentives and their harmful effects when individual incentive pay, including commissions for salespeople, is so very much in fashion these days. Hewitt Associates, the compensation and HR consultancy, reported that in 1991, 51 percent of the companies participating in its salary survey offered at least one plan that tied pay to performance, a proportion that had increased to 77 percent by 2003. Nor is this trend confined to the United States: A 2003 Hewitt survey of 115 organizations in Canada found that 81 percent had some form of pay for performance, up from 43 percent in 1994. Even in Europe, Korea, and Japan, where individual pay for performance is historically much less prevalent, there seems to be inexorable pressure to copy the United States’ example and introduce more individual, performance-based incentives. So, for instance, executives from Hanwha, a large Korean conglomerate, described the pressures they felt to adopt more individual pay for performance. Researchers from Recruit, a Japanese HR and publishing company, also told me about the growing belief that individual financial incentives actually work too well.

Japanese companies should adopt individual pay for performance, even as their own studies showed the problems with moving in this direction.

The big push for incentive pay stems from a belief that if employees were just compensated appropriately, virtually every organizational and management problem could be solved. Company stock price not providing a good enough return for shareholders? Tie CEO compensation more closely to company performance, including shareholder return. Kids not learning enough in school? Institute merit pay for teachers. The government not providing good enough service to its citizens because the workforce has too much of a “civil service” mentality? Implement pay for performance in the federal government.

Some people who question the extensive use of incentive pay point out that employees are motivated by factors other than money and that most surveys show that people rank money far down the list of reasons why they join or remain at companies. I believe, however, that the most fundamental problem with individual financial incentives is that they actually work too well. Financial incentives have powerful effects not simply because people are motivated by the opportunity to earn more money. People mostly want to do a good job and please their colleagues and leaders so they can feel good about themselves and their job performance. Incentives provide information about what behaviors the organization values and which, among the many, sometimes-conflicting priorities, the company most cares about. It’s the old adage of “follow the money” played out as people try to discern what they ought to do in order to do a good job.

But that’s a problem. Most companies have production processes and objectives that are way too complicated to be adequately captured in any incentive scheme. Consider the effects of incentive pay for teachers. The idea is to reward teachers who more effectively teach their students. But how are we to measure what students learn? The most common answer is their score on some standardized test. So teachers are being rewarded for improving their students’ test scores. There are many ways to do this, but certainly the easiest is to give the students the test questions, the answers, or both, in advance. In fact, that’s just what economist Steve Levitt found in his study of teacher cheating. The greater the incentive for improving student performance on tests, the more likely it was that there would be cheating.

Or, to take another example, think about the use of stock options to reward executives for company performance. Seems sensible, until you realize that executives don’t actually have to hold their stock and can choose when to exercise their options and reap the financial gains. So options essentially do reward executives for getting the stock price up—but possibly just for one brief moment of time. There are many ways to enhance the stock price, and certainly one way is to provide financial information that exceeds expectations for company performance, that is almost too good to be true. Turns out that’s pretty much the behavior that stock-option grants have encouraged. There is evidence that the higher the option grants to senior executives, the more likely it is that their companies will have to subsequently restate their financial statements.

The typical response to these tales is to note that the plans were too simplistic and needed to incorporate more dimensions of performance. So, for instance, the city of Albuquerque...
que should have specified not only that its drivers needed to finish their routes but also needed to pick up all the garbage, adhere to weight and speed limits, and so forth. But as soon as the incentive plan is complicated in this way, the next question becomes the weighting given to each of the components of performance—in this instance, picking up the garbage, adhering to the laws, finishing early. Plans quickly become complex. I can recall sitting in the office of Ko Nishimura, then CEO of contract manufacturer Solectron. Ko believed in pay for performance and also understood the complexity of Solectron's business. The solution: an incentive-pay plan so complicated that Ko, a very smart man with advanced degrees, had to take the plan out of his drawer and refer to it as he explained it to me. Although the plan may have been able to capture the complexities of the business in its myriad details, its very complexity had cost it any possibility of guiding behavior. People don't walk around with pay plans in their pockets or complicated details memorized. Ironically, the very thing that is necessary for incentives to guide behavior—simplicity—is the same thing that defeats the effectiveness of such plans except in the simplest of business cases.

By the way, many of the leading compensation consultants fully realize the problems involved in implementing individual incentive schemes. They continue to implement such plans because, as one senior executive of a major firm told me, their clients demand it and if they didn't do it, a competitor would. Moreover, as this executive went on to say, since such plans invariably had problems, the company would get invited back in an effort to fix the problems with the original plan, thereby generating additional work and fees.

It is interesting to speculate as to why companies continue to rely so heavily on financial incentive schemes, given their well-documented problems. Part of the answer may be the “extrinsic incentive bias,” the belief that others are motivated primarily by money even if people know that they, themselves, are not. Believing in the power of financial incentives, they come to rely too much on this tool of management.

But I think an even more important reason may be that financial incentives are apparently easier to tinker with than other determinants of individual and organizational performance. I say “apparently” because as the foregoing examples make clear, financial incentives often have undesired and unanticipated consequences. Nonetheless, one can change a pay system or a set of financial rewards fairly quickly and easily. It is much harder to change organizational culture, people's mindsets and beliefs, their knowledge and skills, and how effectively they work and communicate with each other. Thus, financial incentives offer the mirage of the quick fix—and contemporary management seems to be enamored of that idea. That's the case even though there can obviously be no sustainable competitive advantage from something that is easily observed and readily imitated—and there is almost nothing as readily observed and as easily copied as an organization's financial-reward system.

So leaders face a choice. They can do the hard work and uncover and fix the root cause of performance problems—something that the quality movement and W. Edwards Deming would recommend. Or they can tinker with financial rewards and hope that somehow they hit upon a magic formula that actually captures the organization's priorities reasonably well or that their employees will take the incentive system seriously enough, but not so seriously as to try and game the system.

In this last observation is perhaps the most important recommendation about how to avoid the sins of “commission.” As George Zimmer, founder and CEO of the off-price tailored-clothing retailer Men's Wearhouse observed, you want incentives to be just large enough but not too large. In other words, you want rewards to be large enough to be noticed, and you want to use them to provide an occasion for celebration and recognition, to let the group come together and share successes and enjoy each other's companionship. But you certainly don't want to make the incentives so large that they begin to drive and thereby distort behavior. In Zimmer's wisdom, of course, is embedded a wonderful paradox: Incentives should be used not to drive behavior but, instead, to provide recognition and to share the company's success with its employees.

There are, unfortunately, few shortcuts in leadership—and using financial incentives to fix companies isn't one of them. Companies that succeed in building high-performance cultures communicate relentlessly about what really matters and why. So, at DaVita, the kidney-dialysis company, every meeting or event, including quarterly analyst conference calls, begins with a discussion of the various components and measures of patient care—the company's highest priority. Companies also must ensure that people understand their business model, and what produces business success and why. That entails sharing information and mostly investing a lot of resources in ensuring that people have not only information but the ability to use the information to make better business decisions. Again, DaVita shows what can be done. At DaVita University, the company spends more than $10 million a year educating people at all levels, but particularly its facility administrators and its senior leadership, on the company's values and culture—the DaVita Way of Managing—and also on how to understand the various reports, what its business model is, and how to be more effective in making good strategic and operational decisions.

So the message is: Be careful what you wish for, because you might get it, and implement commissions or other financial incentives with caution. And if you're going to use financial incentives to guide behavior anyway, at least think about how someone who takes the incentive seriously might behave as a consequence. This anticipation will frequently successfully forecast just what people will do, so at least if you get what you pay for, you will be prepared for it.