How PRP produces the illusion of control **and thwarts strategy implementation**

Andrew MacLennan explains...

There can be few more intuitively appealing ideas in management than linking pay to performance. It conjures up all the right notions – leading edge, logical, wise, prudent and equitable.

Plenty of organisations seem to agree. Over 80 per cent of the UK workforce is eligible for some form of performance-related pay (PRP) – a figure that is growing fast[1]. PRP is being introduced to an increasingly diverse range of jobs. Its introduction for teachers is a recent high-profile example of the public sector catching up with the trend.

Not only is PRP becoming more widespread but organisations are also relying upon it more than ever before – especially for the most senior roles. A recent survey reported that the annual bonuses of executive directors and senior executives now average over 40 per cent of salary[2].

The corporate governance movement has fuelled the drive towards PRP. The Greenbury and Hampel committees both recommended that incentive compensation be closely aligned with performance[3]. These recommendations followed the concern, backed by considerable evidence, that the relationship between executive pay and company performance was very weak[4]. Indeed, chief officers' pay appears to be far more closely associated with the size of firms than the returns they generate[5].

So is the widespread enthusiasm for PRP justified? Is the complex apparatus and sensitive stakeholder management required to operate PRP in any organisational role, worth the trouble? The research evidence is far from supportive.

Looking at chief officers first, payments under simple bonus schemes are quite closely associated with firm performance. But of course, that is because in such senior roles, firm performance usually determines them. It is not evidence that bonuses cause or are necessary for superior performance. Ironically, there is now a strong trend towards complex bonus schemes, partly to incorporate more non-financial performance measures for a longer-term view. This move is motivated by the right principles, but complex bonus schemes are less sensitive to actual performance.

Long-term incentive plans (LTIPs) don't fare any better. There is evidence that their design is easily and regularly manipulated[6] and that they handsomely reward average performance[7].

Executive share options (ESOs) might be expected to avoid all these problems. After all, they are surely very directly linked to the performance of CEOs and their top teams. Here, a different problem and interesting irony crops up. The more senior an executive, the more he or she is considered responsible for firm performance, having the remit to manipulate an extremely wide range of organisational variables. However, it is precisely the control over these variables that empowers executives – where they are so inclined – to make self-serving decisions at the cost of the company. We tend to forget, when granting share options (a 'long-term' incentive) that very often the executives receiving them will still be in control of the important levers when these options mature and tempted at that point to make short-term decisions to maximise personal rewards. It is often the dysfunctional behaviour that is delayed, as well as the reward. For example, the use of share buy-back schemes, which increase share prices (but not long-term shareholder return[8]), has increased in line with the use of ESOs and there is evidence that such incentive schemes affect stock repurchase decisions[9]. Just to add to the confusion, many executives receive share options based on a multiple of salary, so at the time of the award, a lower share price translates into a greater number of shares. This diminishes the incentive for early share price increases.

Moving away from chief officers, what about everyone else? Can organisations make PRP work for those in less senior roles, who don't have the power to manipulate LTIPs and share prices? Does PRP support successful strategy implementation?

Tackling these questions is much more complex than studying the link between chief officer pay and shareholder return. A number of interrelated issues crop up.

Firstly, there is the simple question of whether paying people more makes them work harder. It is well established that stretching but attainable goals can motivate people[10]. However, it is also known that easy or very difficult goals are demotivating[11], so immediately a significant challenge is created – repeatedly fine tuning goals that are appropriate for roles and the individuals in them.

It is intriguing that goals can be motivating in themselves. Indeed, there is evidence that the introduction of extrinsic rewards for goal achievement can destroy intrinsic rewards, and cause poorer performance[12]. Why? Motivation guru Jeffery Pfeffer would argue simply that generally people don't work harder for more money – once they have reasonable financial security, intrinsic rewards become far more important. Indeed, pay seems consistently to be ranked fifth or sixth in surveys examining what employees value. When the financial rewards of high performance are stressed, attention to and interest in the actual job itself tends to diminish. As someone once said, "you'll never score a century if you're looking at the scoreboard."

Ironically, very committed employees' performance can deteriorate with PRP because performance criteria are being imposed rather than shaped by strong personal values. Equally, offering PRP may, over time, attract and retain staff who little value intrinsic rewards. An uncomfortable issue arises – does your organisation really want to recruit and retain the kind of employees it has to bribe to do a good job?

There are other problems. Pay is intended to reinforce goals as a motivator. It has an equally strong impact as a demotivator when it is withheld. Not receiving a reward on offer is psychologically indistinguishable from being punished. Line managers instinctively recognise this, which is why they try to give bonuses to average performers. Of course, with restricted bonus pots, if they manage this, the differentiation between high and mediocre performance is marginalised.

Individual PRP can also undermine teamwork as colleagues compete against one another for limited rewards[13]. One solution to this is to use team-based PRP, but this can cause serious conflict between teams, a big problem wherever cross-team coordination and cooperation is important.

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Perhaps most worrying of all, PRP does not address the issue of how to improve performance. It is something of a short cut for managers who don't actually manage staff and support them in their roles. Why go to the trouble of diagnosing problems and finding innovative solutions, if 'tinkering' with the reward system is perceived to deliver the desired results?

Related to this, PRP does tend to crush creativity. Partly this is caused by increased risk aversion, but deeper structural problems are relevant, and these have wider implications.

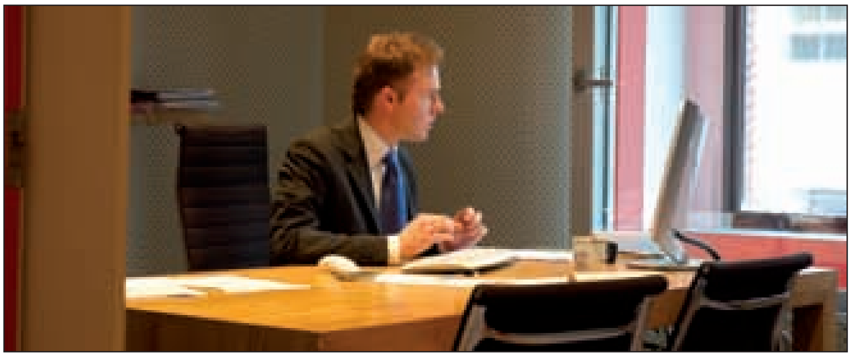
There are clearly many problems with making PRP motivating. But another fundamental issue is whether it can motivate people to do the right things. The logic of PRP is based on numerous assumptions, which are generally not addressed by those designing or researching PRP systems.

Economists see pay as a solution to the 'Principal-Agent problem'. Managers need others to undertake tasks they cannot attend to themselves, so they must find ways of making individuals' goals consistent with those of the organisation. Paying people to undertake specific tasks is the obvious answer, but consider the assumptions this involves. In order to be sure that employees contribute effectively towards strategy implementation, managers must:

- be very clear about the organisation's objectives
- understand the organisation's environment and how it affects strategic choices
- craft a strategy to achieve the objectives
- break that strategy down into activities that can actually be implemented
- determine an appropriate organisational structure and resource allocation system to manage these activities
- create individuals roles within that structure
- define the performance requirements in each role (i.e. specific performance variables, measures and related goals)
- fill the roles and create the right kind of commitment – potentially via pay – amongst the role-holders

If managers can do all that very complex and voluminous thinking perfectly, and the environment doesn't change too much, they might end up with a well-aligned reward system (albeit suffering from the problems with pay discussed so far). However, in most organisations, there are serious misalignments between these elements. Even well aligned organisations will never get all of this 'perfect'.

And therein lies a big problem. If managers can create an effective 'line of sight' between organisational goals and individual roles, employees might have the scope to modify their activities in recognition of where they can make a better contribution, taking into account environmental changes and the needs of the organisation as a whole. However, measures, goals and PRP in particular all have the power to focus the attention of individuals on pursuing specific outcomes, sometimes at the expense of all else. If managers operate like economists – assuming that employees need to be accurately 'programmed' –



they prevent these employees from 'programming themselves', even if their altered actions would be in the organisation's interest. Senior executives should be in no doubt that using PRP narrows the views their employees take, and reduces their focus to achieving a limited number of current objectives. If businesses need creative, outward-looking activity to flourish, PRP is an extremely dangerous choice.

Another major problem is that no matter how simple a job, it is very difficult to create a reward system that is perfectly balanced and representative of the kind of performance desired. In particular, it is very difficult to predict the manipulations of the systems that individuals might attempt. History is littered with examples of reward systems that have been 'played' to the advantage of employees, usually at the expense of their employers.

There are typically many opportunities for such game playing. Performance measurement is notoriously difficult, and individual role holders usually know very well how to ensure controllable metrics are selected. Goal setting is equally difficult, with the obvious problems of politics and negotiation and many other less obvious problems related to ensuring target achievement.

There are various tactics one can employ to reduce the likelihood of both these problems arising:

awarding PRP on the basis of a more rounded, subjective assessment of individual performance, that allows for autonomous changes to planned activities and takes the environment into account; emphasising wider organisational performance component in PRP; extending the time horizon over which performance is assessed; and emphasising wider team-based PRP components.

All of these tactics – many of which underpin the rationale for using LTIPs and ESOs – make the performance assessed more general, and therefore easier to design and harder to manipulate. However for all but the most senior roles, each of these solutions makes the reward criteria much less controllable and diminishes any motivating effect that PRP might offer. This, of course, brings us back to where we started.

Set against all these problems and the evidence for them, the popularity and persistence of performance-related pay looks confusing. Why do so many organisations insist on using a management tool that generally does not work? Undoubtedly, the industry that has grown up around the design and management of PRP systems works hard to ensure its survival. But it is more than that. Senior executives do find the illusion of control remarkably hard to resist, and when PRP has been so generous to them, do they have the incentive to challenge its use?

Those that can see beyond it will of course wonder – if PRP is not the route to high performance, what is? Perhaps there can be little better advice on offer than Alfie Kohn's: "pay workers well and fairly – and then do everything possible to help them forget money."

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