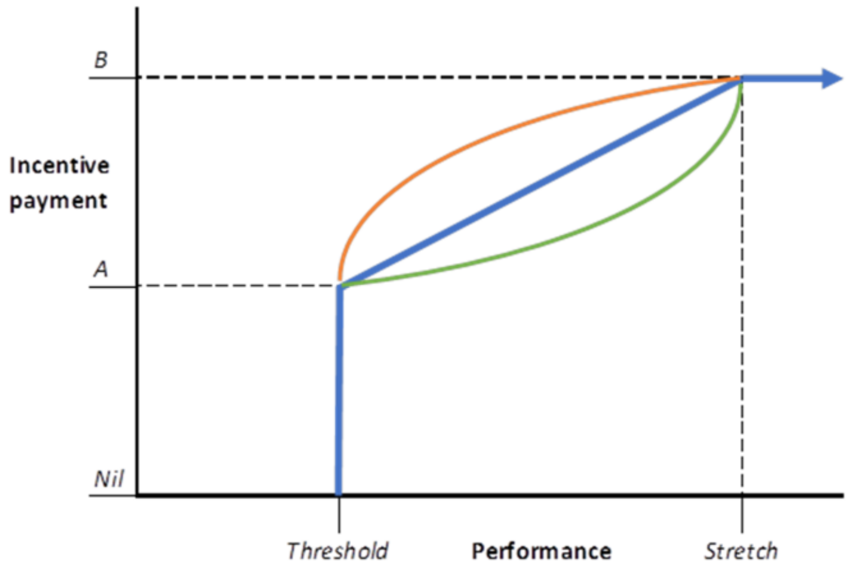
HaRe Group newsletter: **23 September 2014**

Subject: **Why incentives go wrong and how to get their benefits back**

In many industries, there is a long tradition of paying incentives. Remuneration surveys prove the high prevalence of incentive pay for many employees; but do incentive plans always meet their objectives? Almost certainly not – so what are the pitfalls?

You may recognise some of these unintended consequences: ***withholding effort, shifting revenue & expenses between periods (ie. sandbagging), quashing valuable information*** and ***redirecting resources.*** Very often, the causes can be found in easy measures (rather than the right measures), poor benchmarking, or lazy design.

Many incentive plans include a performance hurdle (threshold) that has to be cleared before any incentive payment is earned. There is also a cap on the payment, based on a predicted "best case" (stretch) performance outcome. This design is often charted in this manner:



Criticism of this design is not uncommon. Where the **convex** line defines the performance-pay relationship, this could encourage too much risk-taking. With the **concave** relationship, employees could unreasonably increase their incentive pay with too little performance improvement in the higher levels.

If *Threshold* performance is perceived by employees as unachievable, then they may be motivated to hold back until the following period, partly because there is no penalty for missing *Threshold* by a bigger margin. Likewise, if *Stretch* is reached well within the period, then there is no personal gain in pushing performance higher.

Poor incentive design can also have a corrosive impact on the organisation. I know cases where the *Threshold* payment *A* was so large that managers did "whatever it takes" to pump performance up to that level – their behaviour often offended other employees, and then caused a performance vacuum during the next period.

I've also heard stories of "casual" benchmarking, where budget leaders assign *Threshold* and *Stretch* performance by simply adding an arbitrary percentage onto the prior year's results. In some cases, employees have repeatedly seen their carrot dangling very close in one period, but in the next period, it's pulled far away without justification.

Successful incentive plans usually incorporate these features:

- A tailored plan for each substantive employee group
- Employee participation in design
- Impartial measures – either absolute or relative – that are meaningful to employees
- Strategic, zero-based performance benchmarking (not dominated by prior-year results)
- *Threshold* performance that deserves a minor yet meaningful incentive
- *Stretch* performance that can only be achieved in the very best of all circumstances that are in the employees' control
- For *Stretch* performance, fund an "industry best" incentive – if there are significant factors not in the employees' control that can drive up performance, then manage the maximum incentive to prevent underserved windfall payments

Some companies defer part of the annual incentive payments to senior employees who have the most influence over performance benchmarking. For example, if the subsequent period delivers the same or better results, then the deferred incentive is paid in full.

In my experience, incentives can go wrong for all sorts of reasons. The best designs will vary as much as the business plans they support, but a casual approach will rarely deliver a beneficial outcome for all parties.

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