***The Insightful Leader* Podcast Transcript**
How to Design Incentives That Motivate Employees

Laura PAVIN: How do you get your employees to do their job to the absolute best of their abilities? That's a question every manager at some point asks themselves. I mean, it's kind of fundamental to being a manager. But finding the right recipe for motivation isn't always easy.

One common tactic that managers or executives use is performance pay. Which makes sense: Who doesn't like a juicy incentive? The problem is that, when they're poorly designed, these incentives can backfire, occasionally in really disastrous ways. As just one of many, many examples, take this Wells Fargo scandal that happened around 6 years ago in 2016.

NEWS CLIP: For some Wells Fargo customers, staying on top of money became almost impossible because of Fraud. Federal Regulators say that Wells Fargo employees created of 1.5 millions fake bank accounts and over half a million credit card accounts, without the customers knowledge or consent.

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PAVIN: You see, what happened was that employees were incentivized to sell additional products and services to existing customers in order to reach branch-level sales goals. Reports at the time suggest that employees felt they had to reach these goals to keep their jobs and earn bonuses. And those are some pretty high stakes.

Executives thought that incentivizing employees this way would be a huge boon for Wells Fargo, instead…

NEWS CLIP: The Consumer Protection Bureau slapped Wells Fargo with its largest penalty to date. $185,000,000 in fines…

George GEORGIADIS: This was very destructive for the bank. It resulted in big fines, a big reputational loss. And it also had a big hit on the bank's stock price.

PAVIN: That's George Georgiadis, a professor at Kellogg who has researched why these strategies go awry. He says what Wells Fargo failed to do was think carefully about the incentive structure, because for Georgiadis, the incentive will tell you pretty much everything you need to know.

GEORGIADIS: So Charlie Munger, who is the co-founder of Berkshire Hathaway, is renowned for saying, "show me the incentive and I'll show you the outcome," which is basically another way of saying how powerful incentives are.

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PAVIN: Welcome to the Insightful Leader, I'm Laura Pavin. In this episode we're talking about motivating employees. How to make incentives that work, which strategies are ineffective, and how to avoid total catastrophe. That's next.

It’s important to point out that motivation doesn’t always have to come from the outside. Sometimes people are motivated by what Georgiadis calls intrinsic incentives.

GEORGIADIS: These come from the satisfaction I get and the self-esteem I get from being good at what I do.

PAVIN: Think of this as general job satisfaction. Oftentimes, employees feeling valued and like their work is contributing to something meaningful can be enough to encourage people to work hard. However, extrinsic incentives…

GEORGIADIS: For instance, in a firm setting, the firm might offer employees that bonus for reaching certain targets, or they may offer them a stock ownership plan to work harder, to work longer hours and so on.

PAVIN: Extrinsic incentives, and in particular performance pay-based incentives, have been shown to have a huge impact. For example, meta-analyses, which calculate the effectiveness of individual pay incentives across a number of studies and workplaces, have found that they can increase productivity by as much as 49%. That’s enormous!

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And that’s what we’re here to talk about today: Performance pay-based incentives.

So let’s say that I’m an executive at a company that sells headphones and we need to find a way to get our salespeople to sell more of them. How could I use performance pay to motivate our team members to put in the extra effort?

GEORGIADIS: So before you even start thinking about designing incentives, the very first step is you have to figure out what success looks like.

PAVIN: This might seem like a silly step because sometimes the goals are obvious, but that’s not always true.

GEORGIADIS: Think about a middle level manager at a firm. They do a lot of things. They work mostly in teams. It's super difficult to disentangle what that person is supposed to be doing.

PAVIN: You could set a super broad objective for your manager, like “help the company thrive”, but this is kind of vague and would be difficult to measure. Instead, you should try to be as specific as possible with your performance metric.

So in the case of our hypothetical headphone company, let’s say that success would look like each of our salespeople increasing their sales by 15% over the next quarter. That is a clear measurable metric. And success for our manager looks like an increase in overall sales of 15%.

So once I determine what success looks like, the next step is actually structuring the incentive plan. What do my employees get for hitting their goal?

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GEORGIADIS: The most common incentive arrangement that we see out in the world is a fixed wage, plus a bonus attached to some performance hurdle.

PAVIN: Right, so our employees have their standard pay and if they hit that sales goal by the end of the quarter they get a bonus. Seems great! It's a clear incentive, easy to understand, and it's tied to a specific performance level, one that is easy to measure.

GEORGIADIS: Right. So that's the advantage of this incentive arrangement. The downside is that it provides essentially no incentives away from that hurdle.

PAVIN: What Georgiadis is pointing out is that once your hypothetical employee hits that goal, they're not financially motivated to generate extra sales because the incentive is gone and they won't gain anything by doing more than that initial 15%. And if I can get more than a 15% boost, obviously as a manager I want us to get it! And at the same time, if your employee is off to a very slow start and probably will NOT hit that 15% quarterly target, they ALSO have no real incentive to put in maximal effort.

Okay, so that's one issue with our incentive. The other big problem is what Georgiadis calls gaming.

GEORGIADIS: There are lots of things that we can do to manipulate performance measures. I could achieve those sales by lying to my customers and telling them stuff about the product that's not true, or I could convince them to buy stuff they don't need, or I could do things to get customers to buy this quarter…who would otherwise buy in the next quarter, for instance, by offering a special discount that expires at the end of the quarter. I could drag my feet and get them to delay their purchase.

PAVIN: It turns out that some people are pretty clever and if they can find a way to cheat the system, then…they're going to find it. For instance, with our 15% sales incentive, an employee might hit that goal early on in the quarter. But instead of seeing if they could double their sales, they could delay those sales until the next quarter so that they can more easily hit next quarter's goal and get another bonus.

GEORGIADIS: As soon as you design an incentive scheme, a lot of really smart employees are going to be spending a lot of their time thinking, "how can I increase my pay?" You're essentially putting a bounty on figuring out how to game the incentive system.

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PAVIN: Gaming is essentially what happened with Wells Fargo. Some employees figured out they could easily create fake accounts for their customers without them knowing, and so they did it over and over because it allowed them to hit their performance goals. But it had a huge cost for the bank that in the long run more than negated any benefits from the new accounts.

To be clear, not all employees will attempt to game the system. But if some do, that could still be enough to cause a lot of damage for you and your organization.

Alright, so I'm not feeling great about my incentive plan so far. It seems like I'm going to lose productivity after my stellar employees hit their goal and I'm worried they're going to find ways to game the bonus. What are my options?

Well, one alternative would be to set an incentive plan that's perhaps not AS enticing as a big ol' bonus for clearing a certain hurdle. Instead, you set up an incentive plan that's a little less exciting.

GEORGIADIS: These would take the form of stock ownership, or commissions, or piece rates and so on.

PAVIN: And the way that your employees would receive these rewards, so to speak, would be simply by doing a good job on a regular basis. So, for instance, I could offer my employees at the headphone company increased wages for performing well consistently over the year. That would be hard to manipulate, while still rewarding employees for good work.

The downside of course is that the incentive isn't as powerful. It's not this giant carrot that employees will work extra hard to obtain, and maybe I want a little more bang for my buck.

There is, however, another option for me to consider. And that involves turning a typical bonus incentive into a contest.

Now when I first heard this I was reminded of this opening scene in "Glengarry Glen Ross" when Alec Baldwin's character is berating his employees to motivate them.

MOVIE CLIP: "Oh, do I have your attention now? Good, because we're adding a little something to this month's sales contest. As you know, first prize is a Cadillac Eldorado. You want to see second prize? Second prize is a set of steak knives. Third place is you're fired."

[music]

PAVIN: Obviously Georgiadis is not advocating for this kind of contest OR management style, and this is NOT quite the kind of contest he has in mind. But he does think that setting up a scenario where your employees are competing for something…can be a good–and cost-effective–way to motivate them.

Let's say you only have a limited amount of money to spend on performance incentives, in addition to the regular pay your employees are getting. You could give each employee the ability to earn, say, $500 if they hit a performance target. Or you could lump that money together to create a single pot that's much larger–maybe $25,000–that your employees can compete to earn.

This can be a really effective strategy! That $25,000 is a much more powerful incentive. But you still have a lot of important decisions to make in terms of how well you DESIGN your contest. For instance, if you display how well everyone is doing in real-time, employees who aren't doing well could just stop trying. And the second someone wins the prize, EVERYBODY could stop trying. When Georgiadis and his colleagues built a mathematical model of this kind of scenario, they found that updating competitors on everyone's performance periodically, rather than constantly, was optimal.

But there's still the chance you'll have employees who still aren't motivated by this…because there's only one prize that everyone's trying to reach. And even if they're a top performer, there might be someone that they know is a better performer who will win the highest prize. So how do we motivate those employees?

GEORGIADIS: You can fix this problem by having more rewards or making the rewards more progressive. So instead of having one big prize, you can have one big prize and a second smaller prize and a third even smaller prize.

PAVIN: Brilliant! Or is it? What happens to the performer in 4th place, left off of the prize podium? Is my simple, cost-effective contest starting to get a little too confusing?

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It turns out, there is no single perfect incentive plan that will always be the right choice. Companies are different and employees are different and success looks different from one place to another, too.

There's no GUARANTEE a contest will work at all.

GEORGIADIS: If they're not responsive at all to incentives, then the prize is not going to make a difference because they just don't respond to incentives or they're already working to their max.

PAVIN: Or a contest could create a different problem for you – employees that are really turned off by the gamification of their job. And they even might leave because of that. Everything depends on your company's culture and what you sense motivates your employees.

So if you learn you've got a team that's more motivated by intrinsic incentives...and gets satisfaction by being highly skilled or inspired by what they do? Support THAT. Or maybe other kinds of extrinsic motivation like recognition or career development will prove more enticing.

Talk to your employees…figure out what motivates them…experiment a little bit…and act accordingly. And that goes for any incentive…not just a contest.

But…if you DO think a competition is something they would respond to, setting a contest could give you that little extra bump.

Andrew MERIWETHER: This episode of The Insightful Leader was produced by Jessica Love, Emily Stone, Fred Schmalz, Maja Kos, Laura Pavin and Andrew Meriwether. It was written and mixed by Andrew Meriwether. Special thanks to George Georgiadis.

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