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Applying Behavioral Economics to Pay for Performance

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Although you may not realize it, you probably have been using the principles of behavioral economics for years in designing and implementing your pay-for-performance programs. Every time you create a merit matrix, design a sales commission plan, establish performance norms or decide how to distribute a bonus, you are using behavioral economics. It is a field of study that blends psychology and consumer economics in order to understand why people make sub-optimal decisions about important compensation, performance, financial and health-care matters.

Becoming aware of how you are using behavioral economics and how to make even better use of this fascinating science can help you improve the design of your pay-for-performance plans. This article provides three brief examples of how organizations can use the concepts of behavioral economics to improve employee motivation, overcome rating inflation and secure the most motivation for the organization's money.

1. Improve Employee Motivation

Many compensation programs inadvertently create risk-averse environments, which diminish motivation. For example, employees may look at a merit-pay program with a pool of only 2% to 3% and think they have a moderate chance of getting a small raise and only a small chance of getting no raise. This will lead to risk-averse behavior — employees set lower goals to avoid the risk of failing to meet their objectives — because the potential reward is not strong enough to justify the risk. Many employers use the prospect theory of behavioral economics, which looks at how people make decisions based on risk, to combat risk-averse behavior when they carve out a portion of their merit or bonus pool to differentiate pay for high performers.

Employers can further reduce risk-averse behavior by more clearly communicating what the merit or bonus amounts will be for most people. For instance, if the organization's management bonus pool is funded at 120% of target and the organization intends to give high performers more than that, it might be best to communicate a lower number — 110%, for example — if that is what the average will be. This way, the majority of people who get the average payout will not feel a loss and the high performers will feel a gain. Similarly, employers who communicate "our merit pool is 3%" create an expectation that everybody will get 3%, when in reality they may be planning to pay most people around 2.5% and high performers 3.5% or 4%.

Many employers also use the prospect theory to design compensation plans that motivate employees who exhibit risk-seeking behavior. The most obvious examples are sales commission plans where variable pay is a large component of an individual's compensation. These plans will only succeed if the participants view the potential gain as greater than the potential loss. Hence, the energy and effort organizations put into designing sales commission plans. The upside potential is key to motivation, performance and success.

2. Overcome Rating Inflation

Many employers have implemented default options in their medical and/or retirement benefit plans — a choice is automatically selected unless the employee specifies an alternative. For example, employees may automatically be enrolled in the organization's 401(k) plan, contributing 6% of pay, unless they choose an alternative.

Default options can also be used to improve pay-for-performance

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plans. Many organizations have rating inflation — too many people receive high ratings — which makes it hard to differentiate rewards for high performers. Moreover, some managers complain that performance management and pay for performance are too complicated.

A solution from behavioral economics is to have "meets expectations" or average performance as the default option, and make managers document or justify any above- or below-average ratings to give employees merit increases that vary from the standard. This encourages pay differentiation, which helps the organization reward and retain top performers.

3. Get the Most Bang for Your Motivation Bucks

Conventional thinking suggests that smaller, more frequent rewards (e.g., bonuses) are most effective, but behavioral economics studies reveal two counter-balancing effects:

- **Hyperbolic discounting** is a common bias where most people dramatically undervalue deferred rewards.
- **Probability neglect** is another common bias — people undervalue low-value rewards with a high probability of occurring (e.g., getting your 10th car wash free) and overvalue high-value rewards with a low probability of occurring (e.g., winning the lottery).

Clearly, the size and timing of a reward makes a big difference. People are willing to wait for large rewards. For example, most people eligible for a $5,000 bonus would rather receive a check for $5,000 (minus taxes, etc.) at year-end than have $200 (minus taxes, etc.) added to their twice-monthly paychecks for the next year. This is in part because people do not emotionally connect with the time value of money or the impact of taxes when they think about bonuses. By applying behavioral economics, organizations can get the most motivation from their investment.

Conclusion

These are but three examples of how behavioral economics can be extremely useful in designing and communicating pay-for-performance plans. Although you may not recognize it, you are probably already using behavioral-economics principles to improve how you reward your employees. Taking a closer look at behavioral economics will allow you to use this science to its full advantage.

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