Employee Incentive Systems: Why, and When, They Are So Hard to Change

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In the late 1980s, as part of an effort to beef up its core IT business, Andersen Consulting (now Accenture) began to hire specialist strategy consultants from outside the company. These consultants were more experienced than the usual Andersen employees, and they were accustomed to "much more aggressive individual performance incentives" than was the norm among Andersen's existing IT staff, according to Wharton management professor Sarah Kaplan.

When these new 'hot-shot' hires began to ask for the kinds of compensation they had received in their former firms, the existing employees complained. After all, Kaplan notes in a recent paper -- "Inertia and Incentives: Bridging Organizational Economics and Organizational Theory," co-authored with Rebecca Henderson from MIT's Sloan School of Management -- the existing compensation system "had been reinforced through extensive training and socialization of all new hires." Efforts to change it were "complicated by the fact that no one at Andersen really knew how this new business would operate or what it would take to succeed."

The company came up with a few variations on the existing incentive system that it thought would satisfy the new hires' demands but not alienate the employees already there. It also tried to shoehorn the new hires into the mold of the existing IT staff. Neither effort was successful and many of the new hires simply left the firm. Andersen's efforts to build the new business had a rocky start.

Kodak faced similar issues when it made the switch to digital photography, a vastly different proposition and one that required not just a "transition of technical capabilities from chemical to digital," but a whole new business model, says Kaplan. Senior managers didn't see it that way; they wanted to keep the traditional economic formulas that had been established years earlier by founder George Eastman. Consequently, rather than accept that the digital business required radical change -- including new skills and new managers -- the company tried instead to develop a hybrid business ("film-based digital imaging" and the photo CD). That initiative was "widely viewed as a failure and Kodak eventually created a new digital imaging division separate from the traditional photography group," Kaplan and Henderson note in their paper.

What these two companies have in common, says Kaplan, is that "conflicts around the understanding of what the new business would be, and around how to reward the people building it, led to failures" in creating the type of organization needed to pursue the new opportunity.

Exactly why these conflicts develop is the focus of Kaplan and Henderson's research. "We wanted to understand the systems within an organization that might affect why firms have trouble changing, especially when it comes to a major event, like a technology shift. We started with the question of incentives."

Economists tend to say that if you change the incentive system, then the firm can change as well, says Kaplan. But "in fact, changing the incentive system is not a straightforward activity, because it's not always clear what you are changing *to*," especially when a company is trying to respond to a new

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technology or market shift. What needs to be taken into account in these situations, Kaplan says, "are managers' interpretative processes -- their 'cognitive frames' -- about what is going on in the marketplace. The incentive system and these interpretations are tightly intertwined." Incentives, she adds, rely very much on measures of performance, yet in a time of uncertainty those measures can change in ways that are hard to predict or prepare for.

Incentives are generally defined as "what managers put in place to get people to do their jobs," says Kaplan. In many organizations, they are about things other than straight salary, such as bonuses, benefits, a corner office, a plaque, praise from senior staff, promotions, the ability to work on high-profile projects, and so forth. "I know from the general business press that firms are trying these days to do more with non-salary incentives, like stock options. But no matter what set of incentives a company has, it will encounter the same problems. For example, some companies found that when they offered employees more stock options and lower salaries, employees resisted the move. In a lot of organizations, people only trusted the old incentives."

Kaplan and Henderson's paper deals with incentive structures across the board, in startups as well as more established firms. But they note that established firms face particular challenges because they have long histories of operating -- and rewarding employees -- in specific, well-known ways. "Not only do you have to figure out a new method [of providing incentives to employees], but you also have to break the set of promises you made based on the old incentive system."

Kaplan gives her own case as an example. "As a professor at a university, I would not trust that I would get tenure unless I had seen the university's long track record of granting tenure to professors who meet certain criteria. But when things change, there is no track record. People don't know whether to trust the new incentive system." In such situations, says Kaplan, "the interpretation, or the cognitive frame of what is going on in the marketplace, will dramatically affect how employees understand what they should be doing and thus what incentives might be needed in order to promote a new set of activities."

Ambiguous Measures

In their paper, Kaplan and Henderson focus on the complexities involved in "ambidextrous organizations -- those in which one part of the organization continues to operate as before while another attempts to combine the best aspects of small, entrepreneurial firms with the advantages derived from being part of a more established company."

They look specifically at the constraints established firms face as they attempt to build appropriate incentive systems for new ventures. They argue, first, that "incentives are likely to be based on measures that are subject to interpretation. However, where the economic literature assumes that, even if measures are subjective, they can be instantaneously observed by everyone in the firm, we argue that building a common understanding of the relationship between actions and outcomes ... is not easy."

Each of these measures, the authors write, "can be quite ambiguous, with its meaning only emerging over time as a result of shared history and the slow development of collective cognitive frames .... We believe that in any situation of even moderate complexity, incentives are always defined in relation to other existing cognitive frames of the firm's managers and employees."

The authors also suggest that, in an established firm, the incentive system is likely to be "embodied in a series of relational contracts" -- meaning ones that cannot be fully written out but are enforced by the fear of repercussions if they are not followed. For example, a manager might be tempted to renege on paying a promised bonus for good performance in one year, but will resist because the employee would no longer work hard for a bonus in the future. It is in situations where interactions are repeated that these kinds of relational contracts exist. While the economics literature portrays relational contracts as relatively easy to construct, the authors suggest, in contrast, that these contracts take years of experience to establish, and are based on a shared knowledge of terms and conditions which the employees have come to trust will be

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honored by the firm.

In addition to relying on external research, Kaplan and Henderson talked to employees inside organizations to figure out why their companies find it difficult to respond to change. "People came up with a number of reasons -- the company is paying attention to the wrong customers, or investing in the wrong technology. Those reasons could be true," the authors note, but add that they are "manifestations of problems in the underlying structure of the organization" that affects any efforts at change on a basic level.

"How We Do Things around Here"

In order to explain their thesis further, Kaplan and Henderson look into firms' inability to respond to "architectural" innovation -- innovation that is not about changes in the underlying components but about changes in the links between them. The difficulty comes because these firms continue to rely on "accumulated knowledge, such as mental models and problem-solving strategies, from the previous generation of products." Kaplan and Henderson tie that point into their discussion of the "interplay between incentives and cognition" by suggesting that as these collective frames become "more deeply embedded in the organization, they become implicated in the incentive system and the mutual understanding of 'how we do things around here.' Architectural innovations thus require not only new cognitive frames, but also new incentives."

Some argue that changes in incentives might be difficult because of questions of equity. The authors quote other research suggesting that internal norms make it difficult to offer employees of a new unit any incentives that are significantly more high-powered than those offered to employees in the existing firm. Yet Kaplan and Henderson don't think the equity issue alone can explain "why the incentive regimes in many new units are so similar to that of their parent company. It is often the case, for example, that employees working in sales may be much more highly compensated than many other employees. This creates relatively little tension as other employees come to accept that working in sales is different, difficult and unpleasant, or simply that salespeople need different forms of compensation to keep them motivated."

According to Kaplan and Henderson, many people just assume that if the world changes "such that the firm should reward a different set of subjective measures, the firms can simply announce the change. Employees will know that it is rational for the firm to enforce the new contract, and employers will know that employees will therefore behave appropriately. Both parties will move seamlessly to the new equilibrium and change will be unproblematic."

But that is not what actually happens in "the messy world of a real organization" where significant change requires the establishment of a new contract [incentive system] between a firm and its employees," Kaplan and Henderson argue, adding that establishing that contract involves three particular challenges. First, identifying exactly what an employee is likely to do without being paid to do it, or what his or her true interests are, is a complicated process. Also, employees' interests may evolve over time as they gain experience... and respond to changed incentive structures. Second, there is "tremendous task uncertainty in the mapping from actions to useful output ... For any task of even moderate complexity inside a modern firm, managerial knowledge of these mappings is, at best, a partial and incomplete model that has evolved through many years of individual experience. In the case of an entirely new business opportunity, they are likely not to exist at all. So [for example] when the manager of the new digital film business tells us that the things she is doing are most likely to lead to growth, how do we know if she is right?"

Third, "as situations become more dynamic and ambiguous, it is even less clear what the employees' interests are and it is increasingly unlikely that an employer can easily gain this knowledge. Employees may also react in unanticipated ways to the bonuses that they are offered. ... This problem is often compounded by the fact that the firm has no history of rewarding people who behave in the desired new ways, leaving managers and their employees without a familiar -- and hence effective -- relational

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contract."

One way companies have tried to facilitate this transition is to consider offering new incentive structures to the people in the entrepreneurial units. Yet what happens in these cases, the authors note, is that while managers "recognize that radically different incentive structures might encourage their employees to pursue more high-risk radical technologies, they often hesitate to implement them" because they would "violate the existing relational contract with employees in the traditional business." This results in a "selective intervention" into the incentive regime, one which is bound to fail because the entire system is not realigned to fit the new environmental context.

The Traditional Road to Promotion

All this makes it hard to design incentives for ventures operating in new arenas, but it is particularly difficult in established firms, the authors say. It takes many years for existing incentive schemes to become "embedded both in the cognitive frames of the employees and employers and in the routines and procedures of the firm. ... We suspect it may be harder to learn how to evaluate and reward people than to learn how to do the work itself because there is nearly always a distance between effort and outcome."

Indeed, in established businesses, senior managers have most likely developed intuitions over years of experience that enable them to evaluate their subordinates effectively. "The most senior managers may themselves have been promoted as much on the basis of this knowledge as on the basis of task knowledge because their primary task is to evaluate and reward the people who report to them," the authors write. But this might get in the way of anticipating or seeing changes in the market. "The fact that managers might see things in a particular way is partially a product of their past and current incentives. ... This is especially true for very successful managers who have been promoted on the basis of their subtle understanding of what should be done. If, over time, managers have developed the kinds of local, focused cognitive frames that are likely to get them promoted, then they may plausibly reject information alerting them to radical shifts in the environment as unimportant."

As employers are faced with entirely new markets and technologies, "or with the need to evaluate a manager who is running a highly risky, rapidly growing unit, old intuitions as to what constitutes good efforts are unlikely to be correct. Both employers and employees will need to relearn what constitutes good effort and identify appropriate measures of this effort under changed circumstances."

One particular problem is that employees and employers may develop different senses of what the new incentive regime is -- "so that for any given action, employees may feel betrayed while managers believe they are following through," the authors write. Also, managers might feel that because there are so many complications associated with new technology and new job descriptions, the best thing to do is simply impose an existing incentive scheme on the entrepreneurial venture.

Thus, the "need to use subjective measures and implicit contracts to motivate the organization to do one thing may make it very difficult to do another (such as undertake a radical change). If, as some researchers have argued, routines are truces in the organization, and if these truces embody certain cognitive frames about the business and a set of incentives for acting on that understanding, then any changes in either the frames or the incentives will result in a breakdown of the truce" which in turn can cause misdirected effort and ultimately failure.

Creating a New Model

What can be concluded from all this, the researchers say, is that "first, local routines -- whether tacit knowledge, codes or procedures -- are the product of not only a cognitive process whereby individuals learn about how things are done, but also an incentive-related process, whereby individuals learn what kinds of behaviors are likely to be rewarded. The effects of an incentive regime -- 'I act like this because this is in my best interests' -- cannot be clearly separated from cognition: 'I act like this because this is

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what I believe to be the case.' Rather, cognition and incentives evolve simultaneously in a complex, reciprocal process."

Second, with regards to the adoption of a radical new technology within an organization, the researchers suggest that "the barriers are both cognitive -- 'We know this won't work, and we doubt that it will ever make money even if it does' -- and incentive related: 'You won't pay me for trying to learn.' Because cognitive frames and incentives are tightly intertwined in an organization, any attempt to change one must be accompanied by a change in the other."

Their paper, the authors note, "highlights the importance of the degree of 'embeddedness' of cognitive frames and incentives in dealing with change. The less embedded they are, the more likely that alternative views of the world (views that could better accommodate radical technological change) can emerge. Yet a deeply embedded system has its advantages -- allowing smooth decision-making processes and effective implantation of strategic actions."

A model that views "incentives and cognitive frames as intertwined in an organization recognizes that both are possible. Forces for tradition exist when cognitive frames and incentives are deeply embedded. Yet ... change is possible when managers can reshape these links."

Kaplan and Henderson view their paper as an attempt to dig deeper into the set of explanations for why change can be so difficult to achieve in certain situations. Says Kaplan: "We have tried to explore a potential new pathway for research, linking economic thinking about incentives with what is going on in the organization and, in particular, with managerial interpretive processes."

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