"Currents"

Toward Optimal Business Performance

How aligned incentives improve business performance

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How Aligned Incentives Produce High Performance

Like the current of a river, company incentives act with a force that influences worker behavior. The current can flow in either a positive or negative direction, with weak or strong force.

Organizations are dynamic, ever-changing and evolving over time. To be successful, companies must think directionally, advance toward goals, and keep things moving. Progress requires movement.

Just like the companies that employ them, workers have their own motion. Workers are the engine that propels a company forward—applying human capital to their jobs, making decisions, and doing work. A company that encourages and captures the full momentum of its workers will achieve dramatically higher rates of output and better results. However, some leaders and managers have greater success than others in building positive, cohesive movement in their workers. What factors create productive momentum?

Imagine that each company is a river with a smooth surface. Employees set their boats in the water and begin paddling in a specific direction. From an observer's perspective, employees on one river may appear to be paddling hard but not making significant progress toward company goals. He may conclude that these workers must lack motivation or paddling skill. On another river, which looks identical, our observer may see workers taking their boats quickly toward the desired destination with what appears to be little effort. "Ah," he perceives, "These must be the right kind of skilled, dedicated workers." But what if an invisible current below the surface of each river determines the collective progress of the paddlers—not just their skill or their motivation?

Currents: An Analogy for the Incentives that Influence Worker Behavior.

In reality, few companies achieve optimal business performance because underlying incentives discourage an ideal human capital environment. These incentives are shaped by the business practices outlined in every employment agreement, such as medical benefits, time off, and bonus policies. Like the current of a river, combined incentives act with a force that influences worker behavior. The current can flow in either a positive or negative direction, with weak or strong force.

This paper describes how business practices—sometimes unintentionally—create powerful currents that measurably affect worker behavior. Currents can be subtle and unseen, operating just below the surface. When a seemingly unrelated set of policies combine, they create extraordinary influence over the direction of collective workforce achievement. When designed within a climate of positive, aligned incentives, currents produce high performance and lower use of benefits. When misaligned, the same currents undermine workforce productivity and corporate success.

The direction and strength of currents influence virtually every important worker decision or action.

Although often invisible to observers, the current of collective incentives has dramatic impact on human capital performance; more than any individual employee characteristic. Our empirical results indicate that aligned currents can improve productivity by as much as 10%, while reducing benefits expenditures by 30% or more.

First, the Goal: Optimal Business Performance.

If organizations can readily influence worker performance, what are the outcomes that clearly define success? What behaviors should currents encourage? We define optimal business performance as having the following features:

- Strong company performance
- High levels of job performance
- Low levels of unplanned absence
- Optimal turnover and job fit
- Strong human capital growth
- Active human capital protection
- High worker self-sufficiency
- High engagement in employer-sponsored initiatives.

The Power of Incentives

How does a corporation achieve optimal business performance? Further, how can a company create a continuous current pulling in a positive direction? We begin by explaining the power of incentive alignment.

Workers respond to corporate incentives. It's that simple. Each of us choose to dedicate our time and energy to our work in exchange for the opportunities it brings us, whether in the form of money, recognition, security, commitment to a cause, or something else we value.

At work or elsewhere, human decisions and behaviors are guided by a desire to maximize wellbeing, and minimize loss. This is not a judgment, but instead an acknowledgment of proven economic theory: we each weigh the value of our options and respond accordingly.

Incentives create currents. Business practices that align incentives with business outcomes pull workers toward desired goals. Likewise, business practices that misalign incentives–counter to optimal performance–undermine success. When many incentives align in the same direction, it creates a multiplier effect, strengthening the current. Where misaligned incentives pull and push in different directions, the current is weakened and less effective in moving employees toward productivity. Incentives create currents that explain the collective behaviors of a workforce.

How Incentives Work

Currents result from business policies and practices which determine all that a worker has to gain and has to lose, plus the opportunities and control workers perceive about the future.

The direction and strength of

My success is your success.

currents influence virtually every important worker decision or action. Unless decision makers strategically design their business practices, they often create misaligned currents that silently and invisibly work against positive outcomes. The organization must align what workers have to gain, have to lose, have to protect and have the power to control regarding their employment. Then, all currents pull in the direction of constructive, productive behavior, promoting business performance.

SHARED REWARDS

- **Sharing Positive Results**
- **Investing in Human Capital Growth**

SHARED RESPONSIBILITIES

- **Sharing Accountability**
- **Ownership of Decisions**

Aligned With Optimal Human Capital Performance

Shared Rewards and Shared Responsibilities are the two currents with the greatest influence on employee behavior. Each has two components:

Current Type 1: Shared Rewards (Something to Gain)

"My success is your success," is the essence of Shared Rewards. Any business practice that confirms to workers that the company's good fortune will translate directly to them, and vice versa, is a Shared Reward.

Sharing Positive Results

There is no better or more direct positive reward than variable pay, where a part of compensation is specifically determined by performance. The most powerful incentives are significant financial rewards that are directly tied to performance and allow workers substantial discretion over how they do their jobs.

How does a strong, Shared Rewards current affect optimal human capital performance? Most obvious, shared rewards increase work output. Reports indicate that tying pay to performance increases worker output by 44% to 400%, depending on the type of job (1, 2).

Further, in our own research, we have compared workers receiving variable pay against those who do not in the same organization; those receiving variable pay perform more profitably per labor hour (3). Studies also indicate that profit-sharing increases overall company productivity between 3% and 9% (4, 5). Clearly, if an employee earns more for producing more, the resulting current pulls an entire workforce toward higher performance.

There are many other ways that companies can share rewards with their employees:

- Stock ownership
- Cash back for unused sick leave
- Employee-owned health savings accounts (HSAs), which are fully funded by the company and allow

unused healthcare dollars to accumulate in a worker-owned account

- Offering employees a share of unused travel allowance or other avoided expenses.

Although these examples are not as powerful as variable pay, they do contribute to the overall strength of a Shared Rewards current.

The Shared Rewards current extends positive ripples to other behavior patterns beyond performance to all aspects of the job. Consider the list of behaviors below that become more likely in a Shared Rewards environment.

Investing in Human Capital Growth

Sharing positive results, as described on the prior page, can lead to swift performance improvement. At the same time, corporations can create long-term currents by facilitating workers' growth of personal assets. By assets, we mean both money and human capital assets, like skills, motivation, and health. Asset growth benefits both workers and employers, and serves several purposes.

Growth in human capital assets improves worker capacity—more skills, better health, and greater motivation all lead to better output. As assets grow, the person becomes more valuable to self and family,

Likely Behaviors in Strong Shared Rewards Current

Behavior	Connection to Shared Rewards	Current Pulls Toward
Efficient Work Choices	If this project doesn't increase output, it's a waste for me and the company, and I will earn less	More efficient work decisions likely
Skill Training	If I am more skilled, I may be able to produce more output, and have potential to earn more	Skills acquisition more likely
Healthy Habits	If I feel good, I have potential to produce more, and have potential to earn more	Healthy choices more likely
Recuperation	If I get back on my feet quicker, I can return to work and earn more	Faster recuperation more likely
Overcome Work Challenges	If I can resolve this issue, I can produce more, and have potential to earn more	Efforts to solve problems more likely
Retention	I know I am rewarded for my high performance, and I feel valued	High performers more likely to stay
Turnover	I know I need to work really hard or learn new skills to make more money	Those with poor job fit more likely to quit
Attendance	If I am at work, I have potential to earn more	Attendance more likely

while also increasing in value to the organization. Another component of asset growth is actual monetary savings; money the worker can accumulate for retirement, security, or some other purpose. Growing assets promotes self-sufficiency and choice.

What business practices contribute to personal asset growth?

- Offering a maximum match on 401K
- Generous deposits in health savings accounts
- Training and educational tuition reimbursement
- Opportunities to practice healthy behaviors.

Another strategic reason to promote asset growth is to shift ownership and decision-making power to the worker. Economists have demonstrated convincingly that people protect their own funds more carefully than they protect someone else's. Once money is transferred away from company-sponsored benefits and into worker-owned savings, the spending dynamic changes from one of entitlement to one of protection.

Further, seeing opportunities for the future and building resources and capacity adds value for the individual and employer alike.

Current Type 2: Shared Responsibilities (Something to Lose)

Shared Responsibility means allocating some portion of accountability for undesirable outcomes to the worker. Essentially, a worker is asked to become a responsible steward of resources and benefits awarded to him. Shared Responsibilities also involves giving people latitude and control over their work activities.

Shared Accountability

The first aspect of Shared Responsibility is shared accountability. Perhaps the most powerful contributor to this corporate current is business practices regarding paid time off. In a perfect arrangement of Shared Responsibility, we would follow a simple rule: "A day's pay for a day's work." By not paying a worker for days he does not work, the worker experiences a loss equal to the output lost by the employer.

With no pay for absence at one extreme and 100% pay for absence at the other, there are several incremental ways to strengthen the current of Shared Responsibility as it pertains to paid time-off.

- Paid time-off (PTO) banks give employees a set number of combined paid days off that can be used for vacation and sick leave as needed. While not a direct financial cost to employees, using a sick day requires giving up a future vacation day. In essence this is a cost-share of days.
- Provide less-than-full pay during extended absences. Rather than paying 100%, employers can offer 80%, 60% or less for extended

leave. As such, employees share financial responsibility during times when they produce no value to the organization. Our analyses demonstrate that such policies measurably decrease absence (6, 7).

- Require employees to pay a larger cost-share on medical insurance, or pay an additional premium on short-term disability if they wish to "buy up" to higher coverage. These costs remind employees that benefits are not free, but represent a portion of compensation that detracts from funds available for wages.

Ownership of Decisions

For any of the previous currents to take full effect, employees must have the authority to make decisions about their own behavior.

Sometimes companies sabotage the strength of their currents by creating rules or barriers that interfere with workers' choices.

As an example, a company may offer Shared Rewards for performance, but implement such tight rules regarding how work is done that workers do not feel able to influence outcomes. A poorly-designed Shared Reward can actually discourage desired behaviors. As such, workers should be involved, at least conceptually, in how performance incentives are defined.

Ways that companies can strengthen employee ownership of decisions:

- Consumer-directed health plans (which include a high deductible and a savings account) allow employees to spend their money on services they value
- Emphasis on output instead of process encourages creativity and efficiency in reaching goals
- Allow employees to vote on the services they want covered in their benefits package
- Create flexible work settings that allow employees to manage their time while meeting aggressive performance goals.

Outcomes from Aligned and Misaligned Currents

Current	Strongly Aligned	Misaligned
Shared Rewards	Increased revenue High Productivity Retention of high performers Career advancement	Lower output Lower productivity Turnover of high performers Career stagnation
Shared Responsibilities	High attendance Lower benefit cost Fewer accidents Stronger protection of assets	Higher absences Higher expenditures Retention of low performers

Shared Rewards and Shared Responsibilities — when aligned and combined — create a powerful current.

The more choices and ownership employees are given, the more Shared Rewards, Shared Responsibilities, and Asset Growth will produce optimal human capital performance.

Consequences of Misaligned Incentives

Misaligned Rewards

Because currents pull consistently on all workers in a workforce, misaligned currents have predictable overall effects. Strong Shared Rewards encourage high levels of performance and attention to results. Thus, the opposite will be true when this current is misaligned. When workers do NOT have an opportunity to share rewards, they have less incentive for high achievement. In such environments, organizations notice

- lower productivity
- low efficiency and
- high turnover in top performers.

When Shared Rewards are missing or minimal, high performers learn that their extra efforts do not result in tangible gains. Some high-performers will reduce their effort, while others may choose to seek better rewards elsewhere.

Misaligned Responsibilities

When workers do NOT share responsibilities, they have less incentive to use resources thoughtfully or carefully.

When Shared Responsibilities are weak or misaligned, organizations notice

- high rates of absence and extended leave
- above-average medical costs and
- higher accident and injury rates.

A lack of shared responsibility is also evident in what many describe as a "rich" benefit package. Economically, this approach substitutes paid-time-off or healthcare benefits for higher wages (or other rewards).

By providing more benefits in lieu of higher wages, these organizations become attractive to employees who value benefits more than pay. Employees also experience "job lock," where they stay employed not to contribute to company success, but instead to retain medical coverage or other benefits.

While both kinds of incentives affect human capital performance individually, their combination decides the strength and direction of the collective current. Naturally, if one current is weak, the other will have more pull.

A Fine Balance

Our empirical analysis shows that optimal human capital performance requires a balance of both Shared Rewards and Shared Responsibilities.

On the next page is an alignment matrix, where Shared Rewards are depicted on the vertical axis and Shared Responsibilities are depicted on the horizontal axis. The balance of currents created by Shared Rewards and Shared Responsibilities determine the dynamic between employer and employee.

At the top right, organizations with a strong balance of both Shared Rewards

> *Fortunately, employers have extraordinary influence over worker performance if they acknowledge that incentives drive behavior.*

and Responsibilities create a partnership.

Here, employees recognize that their efforts will result directly in greater success for themselves and the company.

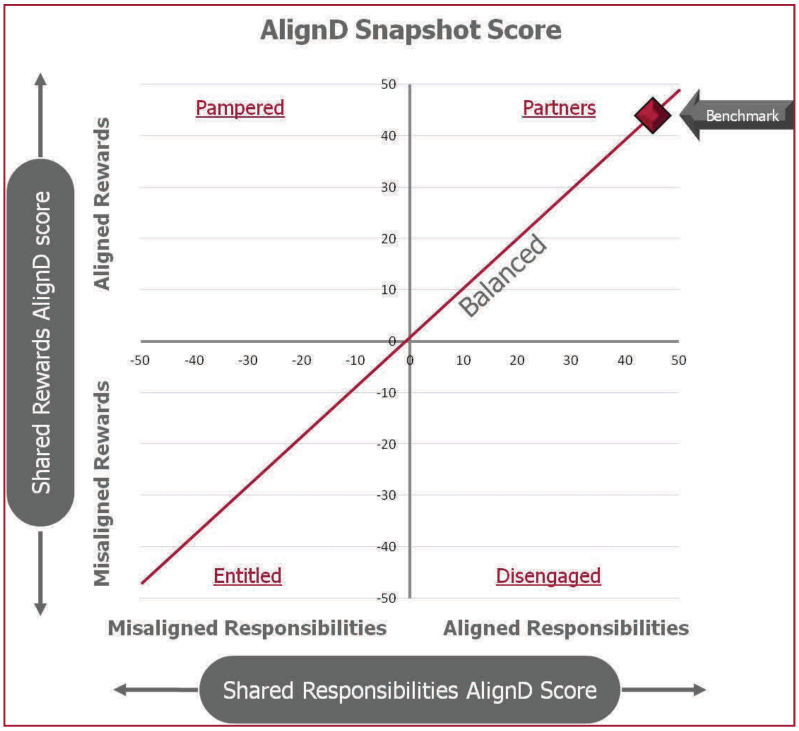
At the top left, employers share significant rewards, but assign very little accountability to employees for managing expenses or building skills. These employees work hard, but also drive excessive spending and cost.

At the bottom right, we find workers who must take responsibility for all costs and difficulties, but who do not expect to gain from hard work. These workers will be largely disengaged; low performing and low cost. Most think of their job as just "putting in time" for contracted labor, not a career.

In the bottom left corner, workers experience an environment where security and protection supersede interest in the success of the company. Workers receive little recognition or rewards, but expect the organization to protect them in times of misfortune. One might frequently hear, "The pay is lousy, but the benefits are great."

Organizations that fall in the "neutral" center of the matrix (dotted line), have inconsistent and unpredictable results. Without currents pulling employees in a discernable direction, organizations find that performance is randomly influenced by recent events inside the organization, isolated personnel dynamics, or the economic environment of the day.

Predictable Employee Dynamics



Cost and Performance Implications

While a simple analogy, the concept of currents has profound business practice implications for organizations. These include:

1. All organizations should asses the direction and strength of these four currents. By simply acknowledging the direction and measuring the force of business practices that determine incentives for behavior, companies can avoid the frustration caused by an invisible and misunderstood corporate current.
2. Next, in an incremental fashion, organizations will benefit from shifting the direction and strength

of each current toward optimal human capital performance. Most steps, such as those recommended above, target policies in compensation and health benefits. These shifts, from our experience, should be cost neutral, balancing increased Shared Rewards, and Asset growth with decreased benefits spending from Shared Responsibilities, improved performance and optimal staffing levels.

3. Policy decisions, which are often made by different people in different departments, must be coordinated strategically to avoid creating conflicting currents.

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