The Top 10 Ways to Ruin Pay for Performance

Lessons from Other Industries

Kevin J. Murphy
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The Top 10 Ways to Ruin P4P

1. Failing to define the "governing objective"
2. Failing to embrace the governing objective
3. Using too narrow performance measures
4. Using too broad performance measures
5. Using too little subjectivity in incentive plans
6. Basing bonuses on beating "target" or "budget"
7. Basing bonuses on beating last year
8. Using funny-shaped pay-performance relations
9. Frequent tinkering with the incentive plans
10. Giving up too soon . . .

1. Failing to define the "governing objective"

- Articulate a single objective
  - Many companies specify a variety of objectives:
    - maximizing shareholder value
    - increasing customer satisfaction
    - increasing market share
    - building the highest-quality products
    - furthering charitable ties to the community
  - Multiple objectives don't tell us how to make trade-offs: need a single governing objective

1. Failing to define the "governing objective"

- Governing objective vs. "stakeholder theory" which argues companies should simultaneously maximize the interests of: shareholders, debtholders, customers, employees, communities, and the government
- Under stakeholder theory, there can be no principled evaluation or measurement of performance
- Governing objective is like the "score" of a sporting event, it tells us which team won. Stakeholder theory (or "balanced scorecards") provide no score

2. Failing to embrace the governing objective

- Once an objective is defined, it must be embraced
  - It must form the basis of all P4P plans
- In for-profit companies: maximize firm value
  - incentive bonuses, stock option plans
  - merit pay increases, promotions
- In health care?

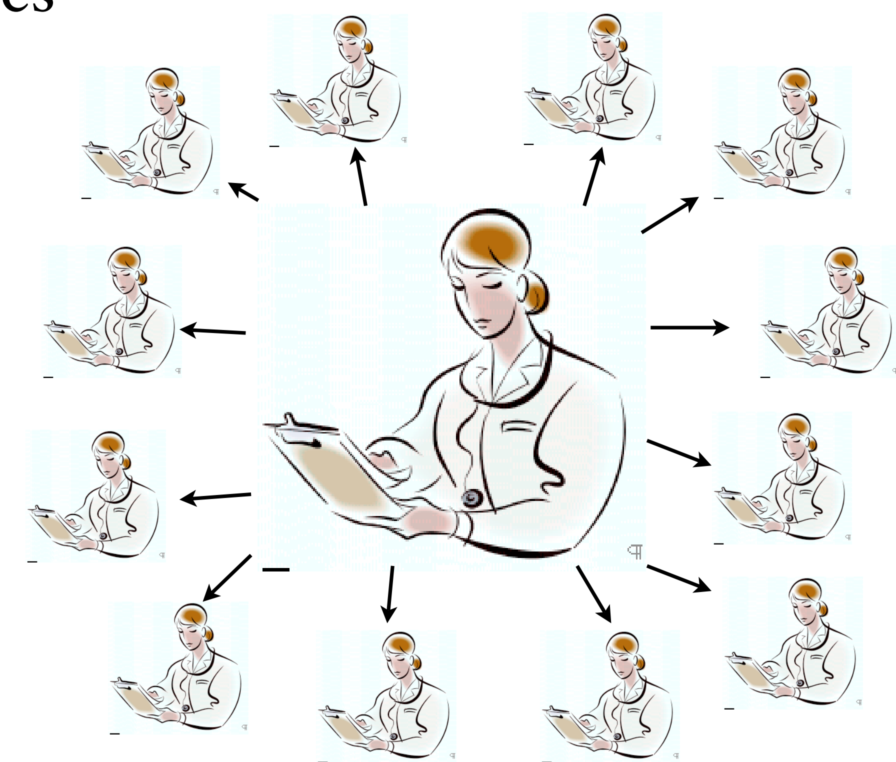
3. Using too narrow performance measures

- Business history is littered by firms that "got what they paid for"
  - Piece-rate workers based on units produced
  - Salespeople paid based on revenues
  - Sears auto mechanics
  - Workers paid relative to co-workers
  - Retiring CEOs paid based on profilts

- Examples of "paying for A while hoping for B" are legion and international

4. Using too broad performance measures

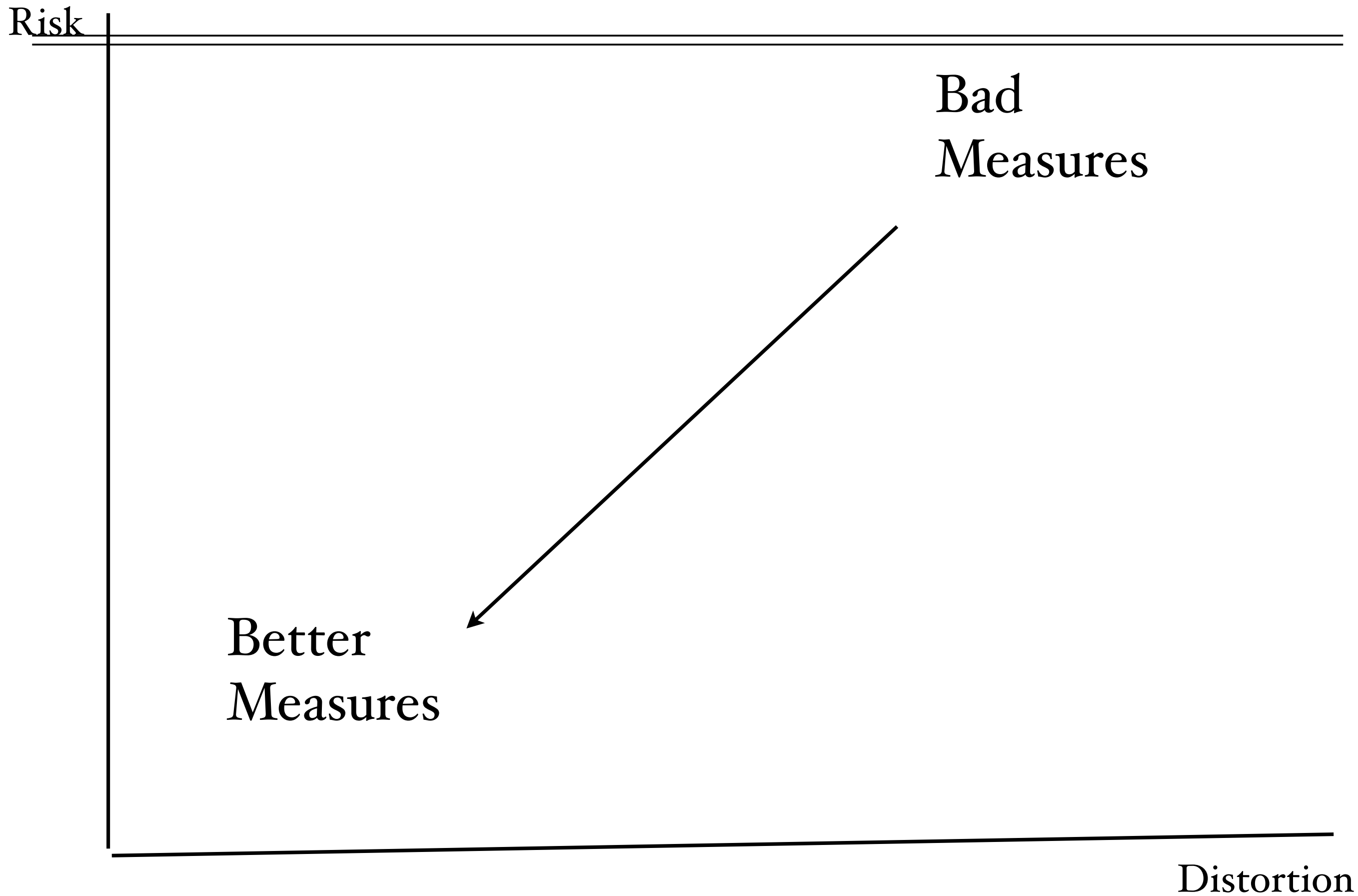
- Trade-off between narrow measures and broad measures



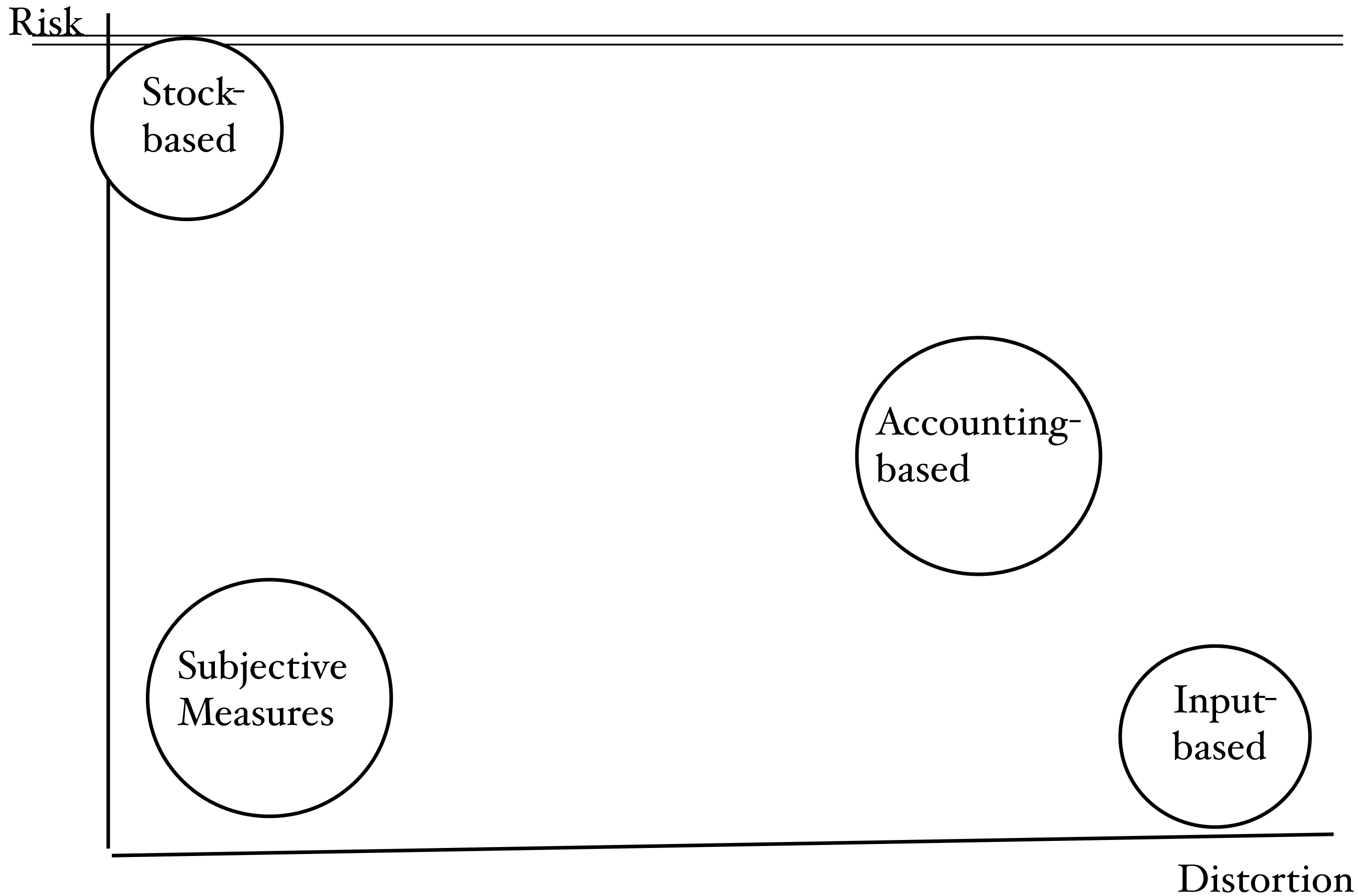
Example from managers: Accounting vs. Stock Price

	Stock-based	Accounting-based
Good	Forward looking Easy to measure Difficult to "game" Covers externalities It's what shareholders want	Good "line of sight" Tells managers what to do Managers can control
Bad	Noisy- imposes risk Over-valued equity	Backward looking Easy to game Managers will do the wrong thing
	Too Broad	Too Narrow

Choice of Performance Measures



Choice of Performance Measures



5. Using too little subjectivity in bonus plan

- Guiding assumptions:
  - *All performance measures are wrong*
  - *All performance measures can be gamed*

- These problems can be mitigated with careful subjective assessments

- Challenges in implementing subjectivity:
  - Employees don't like bad evaluations, managers don't like giving them
  - Few incentives to make careful assessments
  - Requires trust that supervisors are unbiased and diligent

6. Basing bonuses on beating target or budget

- Such systems teach people to lie and provide incentives to:
  - sandbag and distort the target-setting process (i.e., lie)
  - avoid actions that increase future targets
  - avoid profitable long-run projects

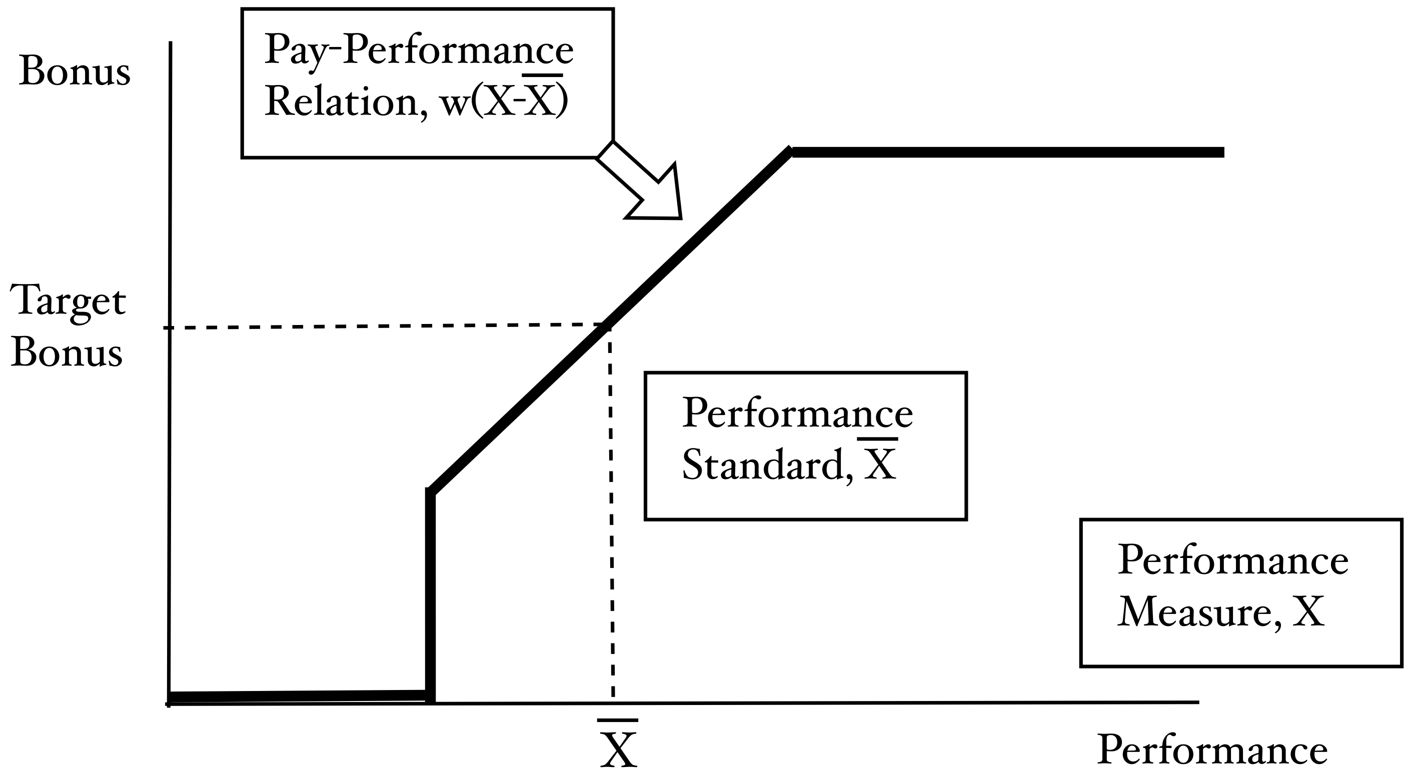
- Solutions
  - Timeless standards
  - Replace budgets with long-run strategic plan
  - Base budgets on external peer groups

7. Basing bonuses on beating last year

- This year's results affect next-year's target
  - good performance is "taxed"
  - avoid having "too good" of a year
  - over time, system produces positive but small growth

- Solutions
  - Watch out for plans that reward growth or improvement

8. Using funny-shaped pay-performance relations



9. Frequent tinkering with the incentive plan

- Tinkering or recalibrating pay plans:
  - creates short-termism
  - destroys trust

- Solutions
  - Implement “sticky contracts” fixed for several years
  - Agree up-front on when (and why) formula will be changed

10. Giving up too soon

- The problems with P4P are testament to the power of P4P
  - *all* pay systems create incentives
  - the challenge is designing systems that create value