

Yes to Variable Pay, but in Moderation

IESE's Josep Rosanas defends variable compensation for recognizing good performance, provided it is based on weak incentives.

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Despite job losses and pay cuts related to the global financial crisis, executives in certain sectors, such as banking, are still earning astronomical salaries. This highlights the difficulty of designing fair and effective variable remuneration systems.

Even so, IESE's [Josep Rosanas](#) defends the benefits of such forms of compensation, provided the compensation is not too high.

The tricky business of incentives

Linking pay to performance is often criticized for making money the overriding motivator.

Companies justify the high salaries of their top executives by arguing that they improve economic performance, though the evidence for this is sketchy. Even when a company boosts profits, it is difficult to determine the extent to which this was due to the executives' singular efforts.

Besides, no matter how good the performance of senior executives, profitable business performance must be at least partly due to the collaboration of others — though it's virtually impossible to measure or quantify the contribution of each and every person. Equally difficult is being able to measure or quantify job complexity.

Moreover, employees who receive variable compensation according to a certain management metric — such as more money for more loans granted — are more likely to act in ways that may be beneficial to them but detrimental to the company, as in the case of mortgage

brokers authorizing more than was advisable during the U.S. subprime mortgage crisis.

The economist Adam Smith recognized this tension as long ago as the 18th century, noting the conflicting set of interests at play between owners and workers.

Variable compensation is necessary

Granted, any incentive system will be flawed, but rather than scrapping variable compensation systems altogether, they should be redesigned, says the author.

First, it is important to distinguish between variable compensation and incentives, which are not the same.

Incentives are payments aimed at enticing executives to do the bidding of company shareholders or owners. This can be dangerous, warns the author.

Variable compensation, on the other hand, can be understood as giving recognition for a job well done. Conceived this way, variable compensation, instead of being a crass mechanism, becomes a "duty of justice," provided it is a weak amount, he adds.

By weak incentives, the author is referring to what the Stanford economist John Roberts proposed: Rewarding employees with a modest amount for achieving some measurable results, but not so much that they seek to engage in maximizing behavior, which is when the perverse effects start to creep in.

Why weak incentives?

The author highlights two main reasons to incorporate weak incentives into compensation systems.

First, weak incentives serve to counterbalance the negative effects of implicit incentives. For example, a fixed salary can be easily taken for granted, as people get paid the same regardless of the results, sometimes leading them not to put in as much effort over time. As such, offering a little something extra can go a long way to keeping them engaged and motivated to achieve some measurable goal.

Second, everyone welcomes a certain degree of recognition for a job well done. Words of appreciation are important, but coupling them with money makes them even more credible, especially as it recognizes that there was a cost involved for those making the effort.

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