# Pay for Performance Raises Performance

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> *»Variable pay for performance raises performance. A very efficient idea, but a wrong one. Fixed salaries supplemented by awards and feedback are much more efficient in improving performance.*

Pay for performance intends to raise performance by paying bonuses when certain targets are reached. However, for complex and ambiguous tasks, evidence-based studies have been unable to show that this is the case. The widespread implementation of pay for performance in areas like management, research, healthcare, or public service, therefore, is not justified. In contrast, variable pay for performance worsens performance of such tasks. Nonetheless, enthusiasm for pay for performance remains strong.

Proponents of variable pay for performance refer to standard economics, in particular to the principal agent view. This theory builds on the model of the self-interested *homo economicus*. It accepts–as a matter of course–that

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compensation should provide big rewards for outstanding and penalties for poor performance.

However, the idea of enhancing performance by pay for performance is wrong in itself. This criticism is substantiated by psychological or behavioral economics and motivation psychology. Many field and laboratory experiments show that people to a considerable extent have pro-social preferences. They work not only in order to earn as much money as possible but also enjoy their work. They are motivated intrinsically and not only extrinsically.

There are five counterproductive effects of variable pay for performance:

1. *Multitasking effect*. Variable pay for performance leads to a goal displacement of extrinsically motivated people. They concentrate on easy-to-measure tasks, which are therefore easy to be rewarded. Tasks which are not easy to measure (e.g., sustainable performance, long-term health, or organizational citizenship behavior) are ignored. With complex and ambiguous tasks, pay for performance is motivating the wrong kinds of behavior.
2. *Self-serving bias*. Empirical evidence shows that most people suffer from an unconscious self-serving bias. Particularly in ambiguous environments, they tend to interpret situations in a way that is advantageous to them. This bias cannot be lessened by penalties, because it is not consciously controlled. Examples are auditors that approve questionable accounts, moneylenders who sell mortgages to people who should not buy houses, or physicians that undertake unnecessary medical treatments.
3. *Gaming the system.* There exists a lot of empirical evidence to confirm that pay for performance promotes manipulative behavior of CEOs, athletes, and other people. Examples are "cooking the books" or doping. As a consequence, pay for performance does not reward performance but rewards manipulation.
4. *Self-selection-effect*. Variable pay for performance attracts extrinsically motivated persons more than intrinsically motivated individuals and thus reinforces the necessity for external control measures.
5. *Crowding out effect*. If intrinsically motivated persons are induced to act according to external control, their intrinsic motivation is reduced. They enjoy their work less and feel less obliged to follow pro-social norms because their autonomy is curtailed. If the reduced intrinsic motivation is not compensated for by external incentives, performance decreases and a vicious circle sets in.

As a consequence, with jobs characterized by high complexity and ambiguity, variable pay for performance should be avoided. Instead, fixed salaries supplemented by awards and feedback are much more efficient to improve performance.