The bonus as hygiene factor:
the role of reward systems in the high performance organization

André de Waal
Maastricht School of Management
Endepolsdomein 150
Maastricht, The Netherlands
andredewaal@planet.nl

Paul Jansen
Professor of Industrial Psychology
Faculty of Economics & Business Administration
VU University Amsterdam
p.g.w.jansen@vu.nl

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ABSTRACT

The ongoing debate about the effects of bonuses on managers' performance and the role of reward systems in organizations has still not led to a unanimous conclusion among academics and practitioners. Those in favor of bonuses state that applying bonuses and putting emphasis on monetary rewards increases productivity and organizational performance, while those against bonuses claim that use of bonuses and monetary rewards leads to counterproductive results. A key question often overlooked in the discussion is: How important is handing out bonuses for an organization to become and stay successful for a longer period of time? This paper describes the results of research into the characteristics of 'High Performance Organizations' (HPOs) and the role of bonuses and reward systems in creating and maintaining HPOs. The research results show that use of bonuses or implementation of certain types of reward systems have neither a positive nor a negative effect on organizational performance. This may be explained by the fact that reward systems are a hygiene factor for an organization. If an organization does not have an appropriate reward system (whether or not including bonuses) it will run into trouble with its employees and have difficulty improving its performance. If it does – a situation which employees expect and consider to be normal - it can start working on becoming an HPO.

1. INTRODUCTION

Ever since the financial scandals that rocked the business world and the worldwide financial crisis that followed, the debate on the effects of bonuses on the performance of especially managers and the role of reward systems in organizations has divided academics and practitioners alike (Sikula, 2001). The divergence of opinion among academics becomes clear when studying scientific research into bonuses and reward systems. On the one side are the proponents of bonuses who state that use of bonuses and emphasis on monetary rewards increases productivity and organizational performance. For instance, Yao (1997) studied the impact of profit sharing and bonus payment on the performance of Chinese state industries and concluded that over half of the value-added growth of these industries could be explained by bonus incentives. Further, Belfield and Marsden (2003) found, while studying the data of the 1998 Workplace Employee Relations Survey conducted in England, strong evidence that the use of performance related pay enhances performance outcomes, although this relationship is influenced by the structure of workplace monitoring environments. Hollowell (2005), looking at the relationship between high-incentive–based executive pay contracts and long-term firm performance found that organizations with a robust executive compensation structure exhibit commensurate superior long-term stock-price performance. In his view, his findings decide the question: ‘Is executive pay a function of performance or is executive performance a function of pay?’ in favor of the latter. Finally, Lazear and Oyer (2009) recently provided an overview of research into the effect of incentives in organizations. Many of the studies reviewed by them showed that incentives can be a powerful managerial tool for affecting individuals’ behavior in a positive way. Specifically, productivity can be increased using incentives like piece rates. Yet, Lazear and Oyer (2009) also discussed studies that showed that even though incentives worked, in the sense that they had a positive effect on results, they did not always work consistently or with prolonged effects and sometimes even had unintended and unwanted consequences like manipulation of results.

On the other side are the opponents of bonuses and monetary rewards. For instance, Bloom (1999) showed that companies with higher pay inequality suffer from greater manager and employee turnover. He also found that major league baseball teams with larger gaps between the highest-paid and lowest-paid players lose more games; they score fewer runs and let in more runs than teams with more compressed pay distributions. It seems that the benefits to the high performers are outweighed by the costs to the low performers, who apparently feel unfairly treated and reduce their effort as a result. Also, Gneezy and Rustichini (2000) found that introducing new incentive schemes in which employees are offered monetary incentives could cause them to perform more poorly than those employees who were offered no compensation. Siegel and Hambrick (2005) showed that high-technology firms with greater pay inequality in their top management teams because of the use of bonuses, have lower average market-to-book value and shareholder returns than firms with more equal management pay. Bruce et al.

(2007), in their study of the relation between executive bonus and firm performance in UK firms, found that increased bonus scheme complexity tended to increase bonus pay-outs without an associated increase in shareholder returns. Some opponents looked at the relation between firm performance and bonuses. Tosi et al. (2000) found during a meta-analytical review of the empirical literature on the determinants of chief executive officer's pay, that firm performance accounted for less than 5 percent of pay variance. This finding was supported by Fattorusso et al. (2007), who found that the financial performance of UK firms showed no significant relation to the size of bonus pay. Duffhues and Kabir (2008) found the same result in regard to executive directors of Dutch listed companies, and therefore challenged the conventional wisdom that executive pay helps to align shareholder interests with those of managers. Stone et al. (2010) plainly stated: financial incentive effects are unreliable. Finally, there are also studies with mixed results. One example is Bonner et al. (2000), who found that the type of task being performed and the type of incentive scheme being employed affect the efficacy of financial incentives. Another is the study by Samuels and Whitecotton (2011), who found that the effects of incentives depend on contextual factors.

In the polemic between proponents and opponents a key question regarding bonuses is often overlooked: How important is handing out bonuses for an organization to become and stay successful for a longer period of time? One way to obtain an answer to this question is by studying the results of research into the characteristics of 'High Performance Organizations' (HPOs). This research aimed at identifying characteristics that explain the sustainable success of an organization (Waal, 2012). This paper discusses the set-up and the results of this HPO research, and describes in more detail the findings in the field of reward systems and bonuses. The consequences of the research results for the role of reward systems in creating and maintaining HPOs are also discussed. Finally a conclusion, practical implications and limitations of the research are given.

2. THE HPO RESEARCH STUDY

The HPO research study (Waal, 2006, 2012) aimed to identify the determining factors that explain sustainable success of organizations. An HPO is defined as an organization that achieves financial and non-financial results that are better than those of its peer group over a period of time of at least five to ten years (Waal, 2012). To identify the elements that make up an HPO, a two-phased study was undertaken. It started in phase 1 with a literature review that focused on identifying characteristics of high performance and excellence, that were subsequently tested in an empirical study in phase 2.

Phase 1: descriptive literature review

The first phase, the descriptive literature review, consisted of selecting the studies on high performance and excellence that were to be included in the empirical study. Criteria for including studies in the research were that the study: (1) was aimed specifically at identifying HPO factors or best practices; (2)

consisted of either a survey with a sufficient large number of respondents so that its results could be assumed to be (fairly) generic, or of in-depth case studies of several companies so the results were at least valid for more than one organization; (3) employed triangulation by using more than one research method (for example a questionnaire and interviews); and (4) had written documentation containing an account and a justification of the research method, research approach and selection of the research population, an analysis of the research data, and traceable conclusions and results so that the quality of the research method could be assessed. The studies to be reviewed were collected by searching the databases of Business Source premier, Emerald and Science Direct, and by Google searches for the words high performance, excellence, financial performance, organizational results, high performing organizations, high performance managers, high performance workforce, accountable organization, adaptive enterprise, agile corporation, agile virtual enterprise, democratic enterprise, flexible organization, high-performance work system, high reliability organization, intelligent enterprise, real-time enterprise, resilient organization, responsive organization, robust organization, and sustainable organization. In addition, business and management books were included in the review. The literature search yielded 290 studies which satisfied all or some of the four criteria. The studies were grouped into three categories: (A) Studies which satisfied all four criteria. These studies formed the basis for the identification of the HPO characteristics. Category A comprised 105 studies. (B) Studies which satisfied Criteria 1 and 2 but not Criterion 3 and Criterion 4 only partly, because the research approach appeared thorough but no exact description and justification of the method used were given. These studies provided additional input for the identification of HPO characteristics. Category B comprised 66 studies. (C) Studies which satisfied Criteria 1 and 2 but not Criteria 3 and 4, so there was no basis for generalizing the study findings. These studies were used as a reference to support the HPO characteristics that were identified in Category A and B studies. Category C comprised 119 studies.

The identification process of the HPO characteristics consisted of a number of steps. First those items were extracted from each of the 290 publications that the authors regarded essential for high performance. Because authors used different terminologies in their publications, the items were grouped according to similarity and each group - later to be named ‘characteristic’ - was given an appropriate description. To test the reliability of this classification procedure, this process was reviewed and repeated by an external academic for the first 90 studies and immediate agreement on the characteristics was 90 percent. The results of this independent review were extensively discussed until agreement on the categorization and the formulation of the characteristics was reached. A total of 189 characteristics were identified. After that, the ‘weighted importance’ (i.e. the number of times a characteristic occurred in the studies; where studies in category A weighted more than those in category B, which in turn weighted more than studies in category C) was calculated for each characteristic. Finally, the characteristics with a weighted importance of at least nine percent were considered to be the characteristics that potentially made up a HPO. As cut-off percentage nine percent was chosen as the as there was a distinct gap around this percentage: several characteristics scored considerably below nine percent while the next closest scoring characteristics scored considerably higher than nine percent, namely fourteen percent. The relatively low cut-off percentage of nine was also chosen because such a lower limit testing many characteristics possible, which is important in exploratory research. The cut-off resulted in a list of 53 *potential* HPO characteristics.

Phase 2: empirical study

Phase 2 of the HPO research consisted of an empirical study. The 53 potential HPO characteristics were included in a questionnaire that was administered during lectures and workshops for managers in Europe, North-America, Asia, Africa and South-America. Respondents were asked to grade how well their organization performed on the various HPO characteristics on a scale of 1 (very poor) to 10 (excellent) and also how the organizational results compared to those of their competitors/peer groups. Two types of competitive performance were distinguished (Matear et al., 2004): (1) Relative Performance (RP) versus competitors: RP = 1 – ([RPT - RPW] / [RPT]), in which RPT = total number of competitors and RPW = number of competitors with worse performance; (2) Historic Performance (HP) of the past five years (possible answers: worse, the same, or better). These subjective measures of organizational performance are generally accepted indicators of real performance (Dawes, 1999; Devinney et al., 2005; Jing and Avery, 2008). Statistical analysis (principal component analysis with oblimin rotation and non parametric Mann-Whitney test) of the questionnaire data revealed 35 characteristics with a strong significant correlation with organizational performance, which were identified as the HPO characteristics. As the data set contained responses from approximately 50 countries, fifteen industries (profit, non-profit and government), and different types of organizations (small, large, family-owned, quoted on the stock market) the statistical analysis was repeated for all these sub-sets, with the same outcome of 35 characteristics.

3. RESULTS WITH RESPECT TO BONUSES AND REWARD SYSTEMS

In 55 of the 290 studies reviewed in phase 1, elements in relation to bonuses and reward systems could be identified. This meant that in nineteen percent of the sources bonuses and reward systems were found to be potentially important in creating and sustaining an HPO. The HPO research yielded twelve potential HPO characteristics with respect to bonuses and reward systems.

1. *A fair reward and incentive structure.* In a worldwide study into the correlation between employee attitudes and financial success, Maister (2001) found that these employee attitudes are positively influenced by reward systems that pay out a fair compensation. In research of Taiwanese high-performing organizations, Huang (2000) concluded that these perform better than low-performing organizations among others because they stress internal equity when designing their compensation systems. Corby and White (2003) discovered, while researching the introduction of performance

pay in England's National Health Service, that the new reward system in theory was viewed favorably but that there was a big fear that the system would not be used fairly and equitably and therefore would be ineffective. Underwood (2004) found that good performing international companies used reward systems that value their employees. Sirota et al. (2005) in their research of what motivates employees to excel, discovered that equity was very important to them: to be treated justly in relation to the basic conditions of employment and having a sense of elemental fairness in the way they are treated, which could be achieved by for employees satisfactory compensation and fringe benefits. Holbeche (2005) called this 'a fair employee deal' which is important for creating the impression of a fair compensation system among employees, as Prinsloo et al. (2007) also found. Burney et al. (2009) found that tying the reward structure directly to a strategic performance measurement system increases the feeling of fairness employees have toward the reward system.

2. *Reward systems that reinforce core values and strategy.* Montemayor (1996) found that American high performing firms although they used many different types of pay policies, yet these policies always were congruent with their strategy, while inferior firm performance was associated with the lack of fit between pay policy and business strategy. Lewis (2000) discovered the same during his research at a bank. Lawler (2003) stated in his overview of HRM practices of companies that the best organizations devised and implemented reward systems that reinforced their core values and strategies.

3. *Pay and incentives linked to long-term performance.* In a literature review into characteristics of high performing organizations, Kling (1995) found that linking employee pay and incentives to long-term performance of the organization had a positive relationship with productivity. Weller and Reidenbach (2011) argue that, in the light of the recent recession and ponderous economic recovery, a better balance in the incentives for short-run and long-run performance has to be achieved as currently corporate managers have stronger incentives to pursue short-term profit-seeking activities than to invest in longer-term productive activities This is also an issue in the public sector as Bebchuk and Fried (2010) state.

4. *Rewards based on relative performance.* One of the key components of the beyond budgeting concept is rewarding success based on relative performance versus competitors, as Hope and Fraser (2003) state. Another form of relative performance is discussed by Guojin et al. (2011), which is peer performance within an organization, in which incentives are paid out after a comparison of an individual's performance with that of his peers in the same function. Matsumura and Shin (2006) found that financial performance improved following the implementation of an incentive plan that includes relative performance measures.

5. *Group compensation.* Hammer (2001), while reviewing emerging business concepts developed by best companies to deal with the increasingly turbulent environment, found that these organizations employed reward systems that emphasized group performance over individual performance. In his

research into productive companies, Jennings (2002) assumed that the pay plans of the companies were the reason they achieved high productivity. Instead he found that these pay plans, which were based on group productivity-based compensation, drove and reinforced the culture that in turn increased productivity. The same was found by Guthrie (2001) for New Zealand organizations. Pizzini (2010) found that productive benefits induced by group incentives used in medical partnerships offset reductions in output associated with free-riding and efforts devoted to monitoring.

6. *Creative and flexible rewards.* In their study of companies which dealt successfully with creative destruction in the marketplace, Foster and Kaplan (2001) found that these companies used reward structures that reflected and increased the freedom these organizations needed to deal with flexibility in the market. Tuominen et al. (2004) found that the higher the level of adaptability of a firm the higher the level of environmental complexity that can be handled by that firm and the better the chances of its long-term survival, and an integral part of that adaptability was a flexible reward structure. Smith et al. (2005) mentioned that high-performing organizations have a wider repertoire of approaches toward reward management than low-performing organizations.
7. *Pay-for-performance.* Bae and Lawler (2000) found that Korean organizations that used a high-involvement HRM strategy achieved better results than those that didn't, and that performance-based pay was an integral part of that HRM strategy. The same results were found by Challis et al. (2005) and Knight-Turvey (2005) for Australian companies, Kok and Hartog (2006) for Dutch small and medium-sized companies, Chang (2006) for South Korean firms, and Origo (2009) for Italian metalworking firms. Joyce et al. (2003) identified that successful US companies used eight management practices, among which pay-for-performance systems. This finding was similar to that of Martel (2002) in a study of some of American best companies.
8. *Emphasis on intrinsic rewards (fun, growth, teamwork, challenge, accomplishment).* Katzenbach (2000) and O'Reilly and Pfeffer (2000) found in their studies of successful and well-known American companies that these constrained monetary rewards in favor of more meaningful intrinsic rewards. Annunzio (2004) discovered that organizations which employed many employees specifically used non-financial recognition for group performance to motivate people. In their study of family controlled businesses, Miller and Le Breton-Miller (2005) found that high-performing businesses put more emphasis on using intrinsic incentives than low-performing family controlled businesses did. Prendergast (2008) even stated that it might be better for organizations to, instead of using monetary incentives, match the intrinsic motivations of employees with the tasks they need to do and as such emphasize the intrinsic nature and reward of the job itself.
9. *Employee stock as incentive.* Guthrie (2001) in a study of New Zealand businesses which used high-involvement work practice found that rewarding employees with stock was used as an incentive instrument. The same was discovered by Knight-Turvey (2005) among successful

Australian companies, and by Chen (2007) for Taiwanese companies. The research results in Taiwan were confirmed in a later study performed by Lin et al. (2010).

10. *A minimum threshold for incentive pay and no cap on pay-outs of incentives.* Zhou and Swan (2003) found that using bonus thresholds in executive compensation contracts is efficient in the sense that it mitigates agency cost. Hewitt (2004) discovered, in a study of high-growth high-profitable organizations, that these companies installed reward systems which had a minimum threshold below which no incentive was paid and at the same time had no cap on pay-outs either. Kelley and Hounsell (2007) identified that using a gain-sharing program without cap resulted in considerably increased profitability at the distribution warehouses where this scheme was used. Sohoni et al. (2011) found, in an experiment at dealerships, that using bonus thresholds reduced sales variance and increased sales performance.
11. *Skill-based pay.* Lawler et al. (1998) in their studies of Fortune 1000 corporations discovered they designed their reward systems in such a way that they supported employees in strengthening their skills so they can take on more decision-making responsibility. Challis et al. (2005) and Knight-Turvey (2005) both found that well-performing Australian companies rewarded their employees for knowledge and skill development, which was also found by Guthrie (2001) for New Zealand organizations. Dierdorff and Surface (2008) found that skill-based pay had a positive influence on the rate of learning of employees. It has to be noted that Giancola (2009) remarked that in recent years skill-based pay is increasingly replaced by competency-based pay.
12. *Rewards for results, not efforts or seniority.* Quinn et al. (2000) concluded that for a company to become a responsive organization it among others has to install incentive systems that reward for performance and not for effort. Guthrie (2001) in a study of New Zealand businesses which used high-involvement work practice found that they specifically rewarded employees for their results, not for their seniority in the company. The same result was found by Knight-Turvey (2005) among successful Australian companies, and also by Goldsmith and Clutterbuck (1997) in a review of the world's most admired companies. Berg and Vries (2004), in their study of Dutch high-performing organizations, stated that these companies used incentive systems that specifically rewarded employees for their performance and punished them for poor results. Sirota et al. (2005), in their research of what motivates employees to excel, found that high-performing employees take pride in their accomplishments by doing things that matter and doing them well and then receiving the (financial) recognition for these accomplishments.

Although most pay-related HPO characteristics may be considered to be fairly independent from each other (e.g. 1, 3, 4, 5), some may be correlated positively (e.g. 1 and 2) or negatively (e.g. 8 and 9, 7 and 11, or 7 and 12). This suggests that there is not one systematic way to construct a reward system suitable for an HPO but that there could be many different types of reward systems that potentially lead to high performance. For the twelve characteristics the weighted importance was calculated and it became apparent that only one characteristic surpassed the threshold of the weighted importance of nine percent: *A fair reward and incentive structure*. This was because the other eleven characteristics were not mentioned enough in Category A studies to surpass the nine percent threshold. This means that previous researchers did not find enough evidence that characteristics with regard to bonuses and reward management play a major consistent role in creating and maintaining HPOs. Further, during the empirical study in phase 2, the remaining characteristic *A fair reward and incentive structure* did not show a significant correlation with competitive performance, which means that this characteristic in the end also was not related to organizational performance. This leads to the conclusion that bonuses and reward systems are not distinguishing factors for creating and sustaining HPOs. Thus, well-performing organizations are as likely to use bonuses or certain types of reward systems as they are not. Using bonuses will therefore not help nor hurt organizations in achieving sustained high performance. In the following section we discuss possible explanations for this research result.

4. DISCUSSION

How can the research result that bonuses and reward systems do not show a significant correlation with organizational performance be explained, especially in the light of the continuing interest in bonuses and reward systems? One explanation could be the very nature of the debate discussed in the introductionary section. In the field of reward management it seems that for every proponent there is an opponent, which means that for the twelve potential HPO characteristics discussed in the previous section there is also proof of the contrary. For instance, for the characteristic *Pay-for-performance* Werner et al. (2011) compared the results of hospitals which used this payment scheme with those of hospitals without pay-for-performance and found that while performance initially improved in hospitals with pay-for-performance, after five years results in both types of hospitals were the same again This result was supported by the research of Mullen et al. (2010) in the same domain of hospitals. Weibel et al. (2010) explained the limited success of pay-for-performance in public sector organizations by stating that pay for performance is generally more costly than it appears because it almost always produces hidden costs of rewards. In regard to the characteristic *Emphasize intrinsic rewards* Mahaney and Lederer (2006), in their research of failures of information system implementations, stressed there should not be an emphasis on one type of incentives but that there should be a reward system based on a combination of intrinsic and extrinsic incentives. For the characteristic *Rewards for results, not efforts or seniority* Fischer (2008) actually found that economically successful organizations used seniority when making decisions about pay raises. When looking at the characteristic *Skill-based pay*, Giancola (2009) categorically stated that this type of incentive scheme has failed because it did not improve results. All in all this there is no theoretical and empirical consensus among academics about pay systems and long-term success, a conclusion which is also reached by Rynes et al. (2005, p. 590) in their meta-analysis of the pay-for-performance literature: “Every pay program has its advantages and disadvantages. Programs differ in their sorting and incentive effects, their incentive intensity and risk, their use of behaviors versus results, and their emphasis on individual versus group measures of performance. Because of the limitations of any single pay program, organizations often elect to use a portfolio of programs, which may provide a means of reducing the risks of particular pay strategies while garnering most of their benefit."

Another explanation for the finding that bonuses and type of reward systems do not significantly correlate with performance could be that the reward system is simply a hygiene factor (LaBelle, 2005). The organization needs to have an appropriate reward system, (whether or not including bonuses) which is considered to be fair and equitable. However, a reward system is not a distinctive characteristic with respect to superior performance. If a reward system is not in place, the organization will run into trouble and opposition with its employees, and becoming an HPO will then be virtually impossible. If such a system is in place - and it does not seem to really matter what type of reward system as long as it is appropriate for the organization in question - employees will consider it normal and will be content, so the organization can start thinking of turning itself into an HPO. The hygiene factor originates from the satisfaction theory of Herzberg (1987), which states that performing well on these hygiene factors does not necessarily lead to high performance, while performing badly will lead to demotivation and dissatisfaction. Therefore Herzberg also referred to hygiene factors as demotivators or dissatisfiers. Thus, the reward system and bonuses can be seen as a form of dissatisfiers: if they are not in place, people will certainly not be motivated to excel. If reward systems and bonuses are considered to be hygiene factors, than organizations should make sure these factors do not cause any dissatisfaction among employees and with that hamper the organization in making the transition to HPO (Jindal-Snape and Snape, 2006).

5. CONCLUSION, LIMITATIONS AND FURTHER RESEARCH

The literature review described in this paper showed there are twelve characteristics, found in research studies into high performance organizations, that have a bearing on the type of bonuses and reward systems that organizations can apply to achieve high performance. However, eleven of these twelve characteristics seem to have a minor role compared to other characteristics found in the literature review (which have to do, among others, with organizational structure, quality of management, quality of workforce, information technology and communication) and did not make the cut into the empirical study. In the empirical study, the remaining characteristic *A fair reward and incentive structure* did not show a significant relation with organizational performance. The conclusion therefore is that using bonuses or implementing certain types of reward systems does not have a positive nor a negative effect on organizational performance. A possible explanation for this result is that reward systems are a hygiene factor for an organization. If the organization does not have an appropriate reward system, with or without bonuses, it will run into trouble with its employees. If it does, which employees expect and consider to be normal, it can start working on improving its performance.

This research result puts the ongoing debate on the use of bonuses and reward systems to improve the results of organizations in a different light. Putting a lot of effort in introducing bonuses or a certain type of reward system and then expecting the organization to improve its results and maybe become an HPO is unrealistic. The reward system is not a determining factor for high performance. There may be other arguments for designing a reward system though. For instance, an organization should not differ too much from other organizations in its sector (Dimaggio and Powell, 1991) or, for equity reasons, internal pay dispersion should not be too large. The practical implication of this study is that organizations should not spend a lot of time on designing and implementing elaborate and sophisticated reward systems to improve performance. They just have to make sure an appropriate reward system is installed that is considered to be fair and equitable by employees. This creates a good foundation for building an HPO.

There are several limitations to this study. Despite the fact that the literature search was extensive, potentially valuable studies may not have been included. In this respect, also it should be noted that predominantly published studies were taken into account, which created a potential bias as unpublished studies may contain different outcomes (Ashworth et al., 1992). Another potential bias is the presence of subjectivity in the choice of literature sources that were included in the study (Ashworth et al., 1992). This problem has been alleviated by including literature from many different disciplines during the selection process. As common in questionnaire-based research and self-reported scores, there is the possibility of attribution. Is it possible that the respondents reporting high performance and those reporting low performance make implicit attributions of characteristics, and in fact, causation. The studies used in the descriptive literature review by definition looked at what organizations did in the past and the results are therefore not necessarily valid for the dynamic future (Morton, 2003).

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