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I Z A
World of Labor
Evidence-based policy making

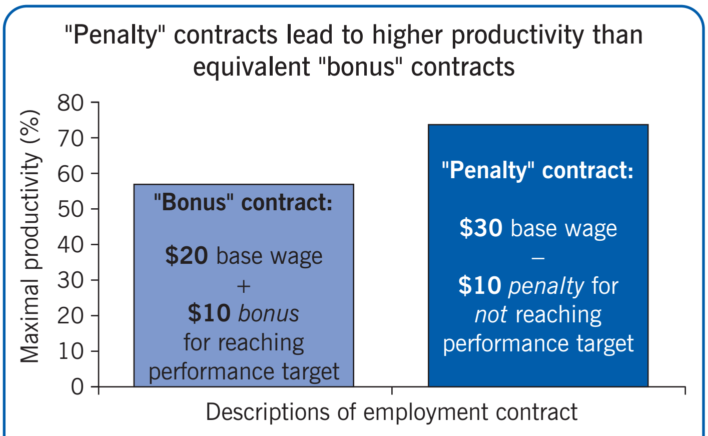
Employee incentives: Bonuses or penalties?

Penalty contracts lead to higher productivity than performance-based bonuses, but at the cost of employer/staff relations

Keywords: employee motivation, bonuses, penalties, loss aversion, contract framing

ELEVATOR PITCH

Firms regularly use incentives to motivate their employees to be more productive. However, often little attention is paid to the language used in employment contracts to describe these incentives. It may be more effective to present incentives as entitlements that can be lost by failing to reach a performance target, rather than as additional rewards that can be gained by reaching that target. However, emphasizing the potential losses incurred as a result of failure may entail hidden costs for the employer, as it may damage the trust relationship between a firm and its employees.



Source: [1].

KEY FINDINGS

Pros

- Employees work harder when incentives are described as entitlements that can be lost by failing to reach a performance target than when they are presented as extra rewards to be gained by reaching that target.
- Modifying the description of incentives has virtually zero financial costs for firms.
- The way incentives are described does not seem to matter for the types of employees attracted by a firm.
- Emphasizing losses incurred as a result of failure does not seem to discourage employees from signing employment contracts.

Cons

- Penalty contracts are perceived as more unfair and controlling than bonus contracts.
- There is some evidence that contracts that emphasize losses lead to more cheating and corrupt behavior among employees.
- When contracts do not regulate all possible aspects of performance, penalty contracts may lead to a reduction of effort in the tasks that are not directly regulated by the contract.
- Penalty contracts are rarely used by firms, suggesting that employers may be particularly wary of their cons.

AUTHOR'S MAIN MESSAGE

Linking pay to performance can be an effective instrument for increasing employees' productivity. However, extra attention should be paid to how incentives are described. Experiments show that employees can be motivated to work harder under "penalty" contracts than under "bonus" contracts. This suggests that firms can reap productivity gains by simply adjusting the language of their employment contracts, at no extra financial cost to the firms. However, employers must be mindful of ensuring that penalty contracts do not induce counterproductive behavior by employees that would have negative consequence for the firm.

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