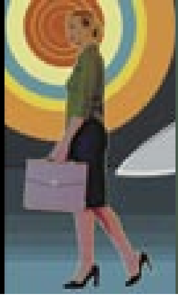
5 WAYS TO KEEP PARTNERSHIPS PRODUCTIVE



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SEPTEMBER/OCTOBER 2005

Why Ca$h Incentives Fail

They're spent on necessities and quickly forgotten. Find out how to keep your incentive programs from going up in flames

Why **Cash** Incentives Fail

Competitive pay and a comprehensive benefits package are great recruitment and retention tools, but money is not effective in keeping employees motivated. New research reveals the value of allowing peak performers to "earn the right to indulge" using travel and merchandise rewards.

by Paul Nolan

Keeping top talent – particularly top salespeople – is crucial to remaining competitive in any industry. Companies are increasingly providing their best workers pay-for-performance bonuses with hopes that they will pamper themselves during off-hours and return to the office rested and ready to work even harder.

But there is a problem with cash rewards that researches say is all but insurmountable: pragmatism. Most of us are hesitant to spend money on non-essentials, even when it's "extra income."

"Consumers often feel guiltiest about the things that provide them with the highest pleasure," says Ran Kivetz, the Sidney Taurel Associate Professor of Marketing at Columbia University Graduate School of Business.

That jibes with a recent survey by Wirthlin Worldwide Research, which posed the question, "How did you spend your last cash reward?" 29% of respondents said they paid bills; 18% didn't remember; 15% said they never received cash; 11% purchased gifts for family; 11% bought household items; and another 11% put the money in savings.

As a result of his extensive research and field tests in behavioral economics as it relates to incentive systems, Kivetz states emphatically that non-cash incentives – "hedonic luxuries," as he calls them – are more effective than cash and cash equivalents (such as gift certificates) in triggering workplace performance that exceeds expectations. Much of Kivetz's research on incentives focuses on the loyalty program model that many consumer marketers use. He states, however, that his findings on which incentives work best holds true in the workplace in sales incentive and other employee reward programs.

Not only does Kivetz's research show that people will work harder for a luxury reward than the cash equivalent, it also indicates that increasing the magnitude of an incentive program's requirements increases the preference for luxury rewards rather than necessity rewards. In other words, the harder someone must work to achieve a goal, the more they want to receive a non-essential item as a reward.

Simply put, no matter how loud or how often your salespeople say, "Show me the money," companies do better for themselves and their employees by using high-end or branded merchandise and travel incentives.

Lock In On Luxuries

Ran Kivetz

Americans are often viewed as the embodiment of overindulgence, yet the truth is many of us loathe spending money on what we perceive to be non-essentials. Indeed, behavioral economists Drazen Prelec and George Loewenstein state that consumers making purchases often experience an immediate "pain of paying," which can weaken the pleasure derived from consumption or even discourage consumption altogether.

Savvy employers turn this reluctance to indulge to their advantage by incorporating just such luxuries into workplace incentive programs.

"On the one hand, people want to indulge in extravagances, but on the other hand, they feel guilty. What they really are attracted to are guilt-free indulgences – when they can get something luxurious without taking money out of their pocket," says Ran Kivetz, the Sidney Taurel Associate Professor of Marketing at Columbia University Graduate School of Business.

Kivetz's extensive research into the choices people make when offered incentives resoundingly support his belief that non-cash incentives are more effective motivators.

In fact, when given the opportunity, many people will "precommit" to indulgence to ensure that the goal of having more fun and luxury is realized. In a series of studies in which thousands of respondents chose between a luxury item and

The Big Picture

Is Cash King?

When presented with a choice of rewards for completing a survey, slightly more than half of all respondents opted to be entered into a lottery for a chance to win $200, while 22% "precommitted" to a chance to win a gourmet dinner valued at $200. The remaining 25% opted for a payment of $2 on the spot.

When a second control group was offered only a choice between the $2 payment or the chance to win a gourmet meal, fully 85% opted for the chance to win the meal. The small payment proved not to be enticing. However, when a third control group was offered a choice between the $2 or being entered into a lottery for $200 (the chance for the gourmet meal was no longer an option), the number of respondents opting for the $2 payment jumped to 35%.

"Hedonic luxuries are more valuable than cash or cash equivalents," says Columbia Professor Ran Kivetz, who conducted the experiment. "People value them much more than they cost a sponsor. I've done other studies where people actually regret choosing cash over luxuries."

a cash amount of equal or greater value, a significant amount of respondents (between 13% and 39%) selected the luxury over the cash (see "Is Cash King?"). When asked why, they replied, "If I chose the cash, I would probably spend it on something I need rather than something I would really enjoy," and "This way I will have to pamper myself and not spend the money on something like groceries."

The Psychological Edge

Interestingly, Kivetz and his colleagues discovered that people are more likely to desire or precommit to a luxury reward rather than a necessity when the requirements to earn the reward are increased. In other words, if you raise the bar in a sales incentive program, it's more likely to be well-received if the payoff is a non-essential item (i.e., something other than cash or gift certificates).

In two separate studies involving consumer loyalty programs (one for a car rental company, the other for a nationally recognized department store), participants were given the opportunity to join a program whose reward was either a one-hour facial or a Swedish massage that they were told had a retail value of $70, or they could join a program that offered a gift certificate for $70 to the participants' local grocery store. Participants in one of the field studies also had the option of not joining either program. (Remember, while Kivetz's field studies focus on consumer loyalty programs, the findings carry over to workplace incentive systems.)

In both studies, when program requirements to receive the reward were relatively low, a higher percentage of participants opted for the program offering the grocery certificate. When the program requirements were increased, participants' preferences shifted to the luxury offer rather than the necessity reward.

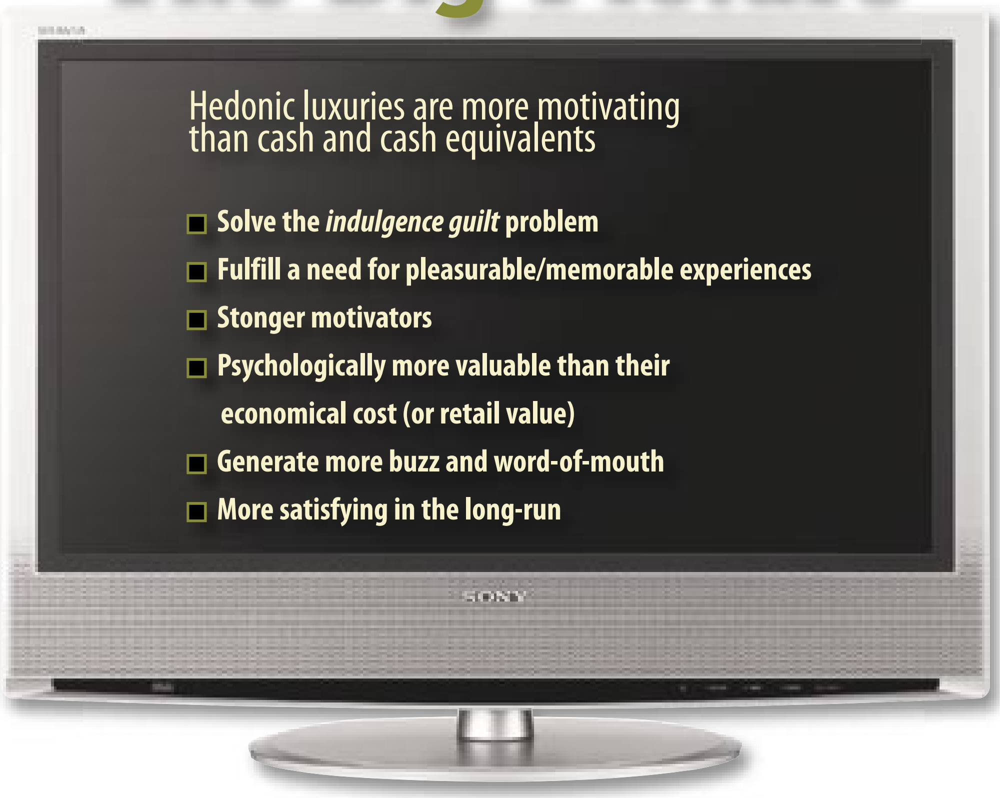
Less for Luxuries

What's more, Kivetz's research showed that the participants will work harder for hedonic luxuries than for necessity items and gift certificates. When the car rental loyalty program offering the luxury reward increased the program requirements from 10 to 20 car rentals, it did not significantly affect the number of people who would participate. However, when the program offering the grocery certificate made the same increase from 10 to 20 rentals, it significantly lowered the number of participants who said they were likely to join the program.

In a separate study, Kivetz gauged how many market research surveys participants were willing to complete for either a luxurious massage (a luxury) or a certificate for four unisex haircuts (a necessity). Respondents were willing to complete on average four surveys in return for the massage and only 2½ surveys for the unisex haircuts.

This is even more impressive in light of the fact that the same respondents

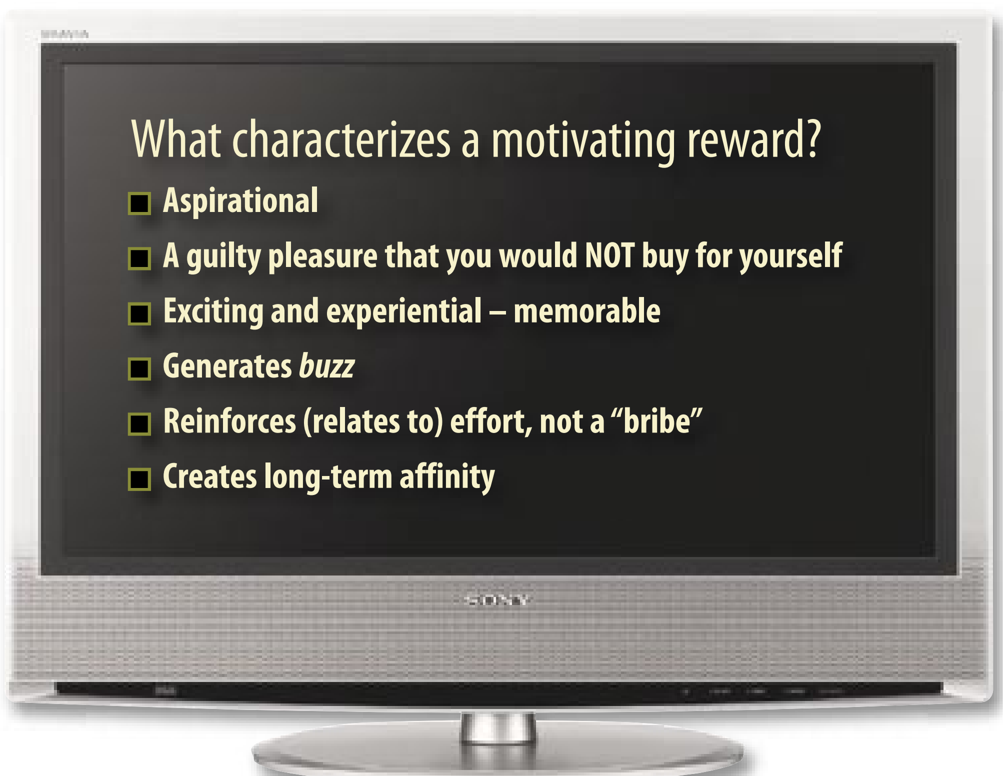
The Big Picture



were willing to pay, on average, $45 for the massage and $60 for the haircuts. Hence, they were willing to work harder for a reward that they attributed a lower value to because it was perceived as a hard-earned (and therefore deserved) luxury.

The lesson: an incentive program is likely to receive more buy-in from participants if the reward is a non-essential item. Luxury rewards are especially effective if the requirements to obtain the incentive are high to begin with or if requirements are increased (say from one program to the next).

"People are willing to work harder for hedonic luxuries. Once you put them in a monetary frame of mind – when they start thinking about dollars – they become more rational, more economical and less willing to work for it," Kivetz says.



When Should You Push Top Performers?

Successful salespeople are typically self-driven, but even the best need encouragement and enticing occasionally. When is the best time to galvanize a salesperson or an entire sales team to achieve a predetermined goal?

To formulate his hypothesis on this question, Columbia University Professor Ran Kivetz borrowed from behaviorist Clark Hull's goal-gradient research from the early 1930s. Hull showed that rats ran faster through a maze as they neared the reward of cheese at the end. Similarly, Kivetz theorized, participants in an incentive program will accelerate the behavior necessary to receive a reward as they get closer to that reward.

In his field studies, Kivetz found that participants in a café reward program accelerated their purchases of coffee as they neared the 10-cup total that would earn them a free coffee. In analyzing 950 redeemed cards (nearly 10,000 individual purchases), Kivetz found that the average length of time between purchases decreased from almost 3½ days for the first, second and third cups to about 2½ days for the sixth through 10th cups.

Consistent with the idea that motivation depends on the distance from the goal, participants who finished one card and started a second increased the time between purchases at the beginning of the second card and accelerated again as they neared the 10-cup goal a second time. Similar results were seen in a program sponsored by a developer of music organizing software that offered free downloads after visitors rated a certain number of songs.

An additional significant discovery was that the "illusion of progress towards the goal" also motivated purchase acceleration. A separate group of participants was given a 12-cup coffee card with the first two cups already credited. Despite needing to fulfill the same 10-cup quota as the first group to qualify for the free coffee, the 12-cup group reached that mark almost three days faster than the 10-cup group.

What does all of this mean for sales managers attempting to motivate the troops?

"People will accelerate their effort in your incentive system as they get closer to their goal," says Kivetz. He also found that people are significantly less likely to drop out of incentive programs as they near the reward, and those who reach the goal are highly likely to stay involved.

Kivetz's recommendations for sales incentive programs as a result of these findings:

- **Create highly visible reward meters so participants know how close they are to receiving a reward**
- **Target and time communications and promotions to participants as they get closer to a goal**
- **Create the illusion of goal progress by starting participants off with points or some other credit that instantly vests them in the program**
- **Build an accelerating or tiered reward structure that allows participants with equity to improve their status**

Why incentives?

■ **Fewer than** one in four American workers is working at full potential; half of all workers do no more than directly asked, and 75% of employees say they could be more effective in their jobs, according to the Public Agenda forum.

■ **70% of** unhappy customers abandon vendors because of poor service, according to the Forum Corp.

■ **A 5%** increase in customer retention can increase lifetime profits from a customer by 75%, according to the Loyalty Effect by Frederick Reichheld.

■ **Competitive** pay and a rich benefits program may attract talent, but a Towers Perrin survey of 6,000 employees working for major North American companies shows that recognition programs, advancement opportunities, a culture of teamwork and innovation, and a clear line of sight between what employees do every day and how the business performs are more effective in engaging workers on a daily basis.

Why non-cash incentives?

■ **Nearly three-fourths** of respondents to 2005 survey of workplace managers agree that they can build more exciting and memorable incentive programs around travel and merchandise rather than cash.

■ **In the same survey,** 53% of respondents believe that employees tend to look at bonus payments as "something they are due."

■ **A *USA Today*** survey found that 93% of those polled prefer travel over other awards, mainly because it's something that many people are not able to buy for themselves.

■ **A University of Chicago** study found that while most people stated a strong preference for cash, their performance was markedly better when they were in pursuit of a non-cash incentive. If you ask workers what they want, "cash" is usually the instant reply. But the right question, says Scott Jeffrey, assistant professor of management sciences at the University of Waterloo in Southwestern Ontario, is "What will you work hardest for?" And whether they realize it or not, tangibles is the answer.

Cut the *Cards*

Gift cards are easy to administer, but they don't drive performance as well as non-cash incentives

Gift cards – the quick and easy substitute to finding a "real" gift for a birthday, holiday or other occasion – have invaded the workplace. Corporate use of gift cards and debit cards has increased exponentially in the past decade.

And why not? Gift card proponents will tell you that they are easy to administer, provide freedom of choice to recipients, and require minimal effort in terms of a structured recognition program. But the fact is the very features that are used to promote gift cards are also reasons why they don't work well in incentive programs.

"Hedonic luxuries are more motivating than cash and cash equivalents," says Columbia University Professor Ran Kivetz. "They generate more buzz – more word of mouth. I have found empirically that these types of rewards are less effective than more pleasurable luxuries."

Gift cards violate some widely held tenets of effective incentives:

- **They state the retail value**
- **Their perceived value is the same as the cost to a program sponsor (or may even cost more if service charges are added)**
- **They often are spent on necessities, are "regifted" by a recipient to someone else, or never get redeemed**
- **Trophy value is lost because recipients don't show off gift cards**

Switch From Debit Cards Produces Dramatic Results

Field studies show that gift cards are not as effective in improving workplace performance as non-cash incentives. A major consumer electronics manufacturer sponsored a yearlong incentive program in which independent dealers were offered deposits into debit card accounts for selling that company's products. At the conclusion of the year, the offer was switched from debit cards to AwardperQs, a non-monetary incentive system from Minneapolis-based BI in which program participants accrue points that can be exchanged for merchandise and travel rewards.

The cost to the program sponsor remained unchanged, as did the program structure and rules for participation. The response, however, differed considerably. The company enjoyed a 35% increase in sales results over the 12-month period following the replacement of the debit card offer.