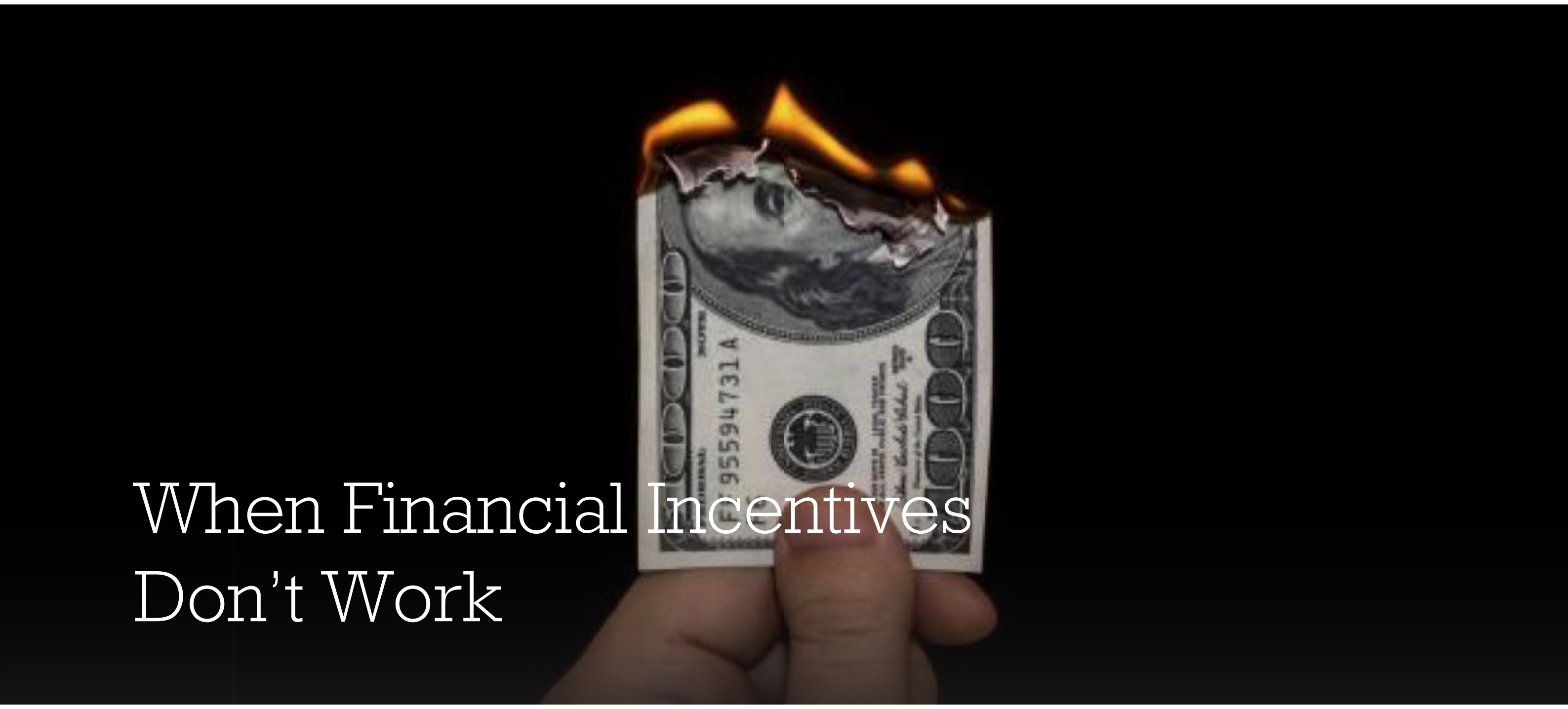


When Financial Incentives Don't Work

Performance incentives may encourage employees to deliver but when it comes to innovation it's by no means certain they trigger the best results.

To balance the need for short-term efficiencies against long-term innovativeness and sustainability, organisations are increasingly under pressure to take an ambidextrous approach: exploiting existing knowledge and capabilities, while exploring unfamiliar and untested territories.

Given the tradeoffs and tension between exploration and exploitation and the difficulty of simultaneously pursuing both, **studies** have highlighted the need to separate these activities at the organisational-level (either temporally or between different units). While such structural separation is a useful framework to think about how an organisation *as a whole* can achieve a healthy balance between exploitation and exploration, our understanding of how to actually encourage *individual members* to switch between these two opposing strategic objectives is limited. Not surprisingly, individuals are **suggested** to be more reluctant to engage in exploration than exploitation activities as the outcomes of the former activity are more uncertain.

Money as a motivator

Performance-based financial incentives have long been used to influence individual behaviour. However, monetary rewards can stifle creativity, motivating individuals to exploit existing knowledge and technology for fast success and payoffs rather than take on exploratory activities which take longer and are less likely to produce positive results. Recent **research** using fMRI scans to examine individual's search behaviour found a strong correlation between activations of reward-related brain regions and exploitation activities.

To gain a deeper understanding of what motivates individuals to explore or exploit, we took the opportunity to examine the behaviour of sales employees (merchandisers) at a South Korean e-commerce firm as it went through a radical compensation scheme restructure. Our research, **How Performance Incentives Shape Individual Exploration and Exploitation: Evidence from Micro-data,** included interviews with both merchandisers and executives and data taken during the 30-month period between 2011 and 2013 when the company moved from a pay-for-performance incentives system (paying merchandisers a low base-salary plus a commission according to sales performance) to a fixed-salary system (paying a higher base-salary but eliminating performance-based commission). Maximisation of revenue in any deal requires the careful selection of suppliers and products. The job of the merchandisers was to identify and negotiate with suppliers, by either exploiting deals they had already sourced and sold before (re-merchandising) or exploring for new deals and products not previously sold through their platform.

Removing performance incentives

We found that following the withdrawal of performance incentives, merchandisers engaged in greater exploration of new commercial ideas. Interestingly this effect was driven by high-ability merchandisers who, finding it easier to meet the new (lower) minimum targets, had more slack in time and resources to engage in uncertain exploration for new commercial products. With financial incentives removed these individuals admitted to being more inspired by natural curiosity and a personal interest in increasing their knowledge.

However, this pattern of greater exploration was less obvious when individuals were underperforming their peers. In these cases individuals, influenced by competitive peer pressures, were motivated by the desire to "catch up" with their higher achieving colleagues, prompting them to resorting to behaviours known to produce fast, short-term results.

Improved quality

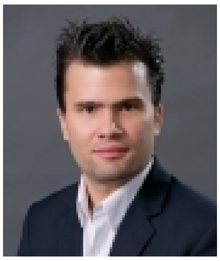
Surprisingly, removing performance incentives also had an impact on the quality of exploration conducted. Contrary to common assumption that financial rewards are closely linked to the alignment of individual behaviours with the firm's best interest, there was no indication the removal of 'bonuses' led to the 'misbehaviour' of individuals. In fact, quite the opposite, instead of shirking and engaging in random attempts of exploration, merchandisers, driven by interest, curiosity and a desire to learn were actually more motivated in their behaviour. They engaged in intelligent, purposeful exploration, refining their knowledge and building new relationships enhancing their social and human capital. **Prior research** has shown that as individuals accumulate knowledge and skills, they learn from their experience to achieve greater performance.

This increase in exploration performance after the reduction of performance-based incentives was found to be particularly high for individuals working in 'noisy' or complex environments which required a deeper level of understanding of the product.

Of course there is the danger that, by offering stable incomes and a low risk environment, firms attract undesirable employees with lower ability at exploration. Managers can address this by carefully screening new employees on past activities at their previous firms and maintaining the flexibility to terminate an employee's contract if they fail to meet performance expectations.

Identifying tools for innovation

While our research shows how the removal of performance-based remuneration can motivate employees to be more explorative in their innovation activities, there is no implication that financial incentives are without value. What we are suggesting is that managers should think about how they want their employees to innovate and look at the tools available to best induce them to perform these activities. If companies want individuals to exploit existing knowledge and technology for greater efficiencies, performance-based incentives work very well, but they should keep in mind that fast exploitation rates can drive individuals to **become biased against exploring** new alternatives. When pursuing radically new ideas or technologies, employees need to know they won't be penalised for following paths which may take longer or lead to less certain results.



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