Behavioural Economics in Reward

By Carmen Arico

We have all seen the reminders from SARS - #Yourtaxmatters, on billboards all around the country. We have wondered where the chips and chocolates at the till points in Woolies have gone to, replaced by healthier alternatives such as rice cakes or vegetable chips. We have all had the emails from Discovery Vitality, reminding us to complete our health checks or attend our local gym. On a more global level, we have all seen and heard the reminders that "Washing hands helps reduce the spread of Covid."

These small reminders, while innocent and seemingly inconspicuous on their own, are a perfect example of Nudge Theory at work.

But what exactly is Nudge Theory?

Nudge Theory is an economic theory developed by Richard Thaler, an American behavioural economist, author and recipient of the Nobel Memorial Prize for Economic Sciences. The principle behind nudge theory is that people's behaviour, either good or bad, can be influenced through *nudges.* Nudge theory is about using 'the marriage between economics and psychology' to guide or encourage certain behaviours without explicit instruction for people to make better choices in their own interests.

Traditionally it was assumed that people made rational choices in pursuit of self-interest. Behavioural Economics has flipped that view entirely on its head and assumed that human beings, by design, are irrational creatures who are susceptible to a wide variety of biases and make decisions based on incomplete data, flawed logic, and emotions. These decisions can oftentimes result in far-reaching blunders in personal finance, healthcare, or other life or career choices.

But how does this apply to us as Reward Professionals?

Behavioural Economics (BE) plays a big part in Reward strategy, whether we have been aware of it by its name or by understanding its impact in the organisation. We all know that employees make decisions about their employment and career for a variety of reasons. Taking a job that has a higher guaranteed base salary over variable pay or moving to a company with a shorter commute and therefore lower fuel costs. But this also incorporates employees working out exactly how well to perform to obtain the greatest incentive. Using this knowledge of employee behaviour, Reward professionals can apply sound Behavioural Economic principles to design reward programmes that emphasise both extrinsic motivators – *tangible rewards like money* – as well as intrinsic motivators – *adopting behaviours that result in personal satisfaction and fulfilment*.

So how can we apply Behavioural Economics (BE) in our daily lives as Reward Professionals?

There are a wide range of BE applications that we have at our disposal which can help our clients meet their Reward strategy and wider HR or Organisational objectives. These are just some of the applications below:

Hyperbolic Discounting

"In essence, hyperbolic discounting is the human tendency to prefer smaller payoffs now over larger payoffs later, which leads one to largely disregard the future when it requires sacrifices in the present."

— *Alan Bellows*

Richard Thaler developed a BE intervention called “Save More Tomorrow", which was designed to make saving for retirement as easy and painless as possible. The intervention consists of three elements:

1. First, asking employees to commit now to saving more in the future (usually done around pay review time when employees are feeling flush) – this helps avoid present bias (*the human tendency to prefer smaller payoffs sooner over larger payoffs later)*
2. Secondly, automatic increases in retirement contributions are linked to future pay increases – this minimises loss aversion (*the human tendency is to minimise risk and loss at the cost of potential gains*) as take-home pay does not decrease and takes advantage of the normal tendency to procrastinate by making the choices automatic.
3. Finally, once employees are enrolled in the programme they stay in the programme unless they opt out

Reward professionals with a good understanding of hyperbolic discounting can apply these principles to the design of an incentive programme. For example, accelerating payouts in the first few months of the plan year, generating early excitement about the plan, or even allowing for smaller rewards to be given immediately that can be more motivating than the promise of larger rewards several months down the road.

Availability Heuristic

Mentally taking the path of least resistance by using the loudest, most prominent, or closest information as a mental shortcut (heuristic) and generalising it, often in error.

An example of the Availability Heuristic is that employees who do not see others being recognised or rewarded may consciously or subconsciously conclude that the organisation simply does not value employees. Reward professionals can prevent the organisation from falling into this trap by ensuring that employees are recognised prominently and that employees can see their peers being rewarded and recognised.

Crowding out

Where the presence of an extrinsic motivator (such as a financial reward) ‘crowds out’ the intrinsic motivator (the desire to do a good job)

Rewards should be designed to have both tangible and intangible elements –intrinsic motivators are extremely important, as we all know from Maslow’s Hierarchy of Needs.

When Reward professionals are designing rewards, they should incorporate both these elements. It should be noted that if a financial reward is offered immediately vs. an experiential reward a few months in the future, most employees will prefer the immediate financial reward, which is a good example of the hyperbolic discounting that was mentioned earlier. Employees want to be recognised for a job well done, and if incentives are poorly designed, the financial incentives awarded can undermine the intrinsic motivation of the employee. Therefore, Reward professionals should design incentive plans with financial rewards with a great deal of caution but not exclude them entirely. These types of incentives tend to work best with clearly defined, task-oriented objectives where intrinsic or other motivators are not necessarily required. More complex tasks, which require a greater element of emotional or mental labour should incorporate more intrinsic motivators.

Loss Aversion

The human tendency is to minimise risk and loss at the cost of potential gains.

How many times have we, as Reward professionals, seen a traditional pay-for-performance plan fail to work, even if all pay-for-performance principles have been adhered to? This is likely due to hyperbolic discounting as mentioned earlier in this article, in which our perceived value of a reward diminishes over

time. The crux of the loss aversion concept is how someone perceives the value of gains versus losses – the theory states that individuals tend to subjectively place a higher weighting on the value of a loss compared to a gain. An example of this would be someone who loses R10 today and finds R10 tomorrow – in their mind they have not 'broken even' as they have placed a higher weighting on a loss than the gain.

A more controversial view of loss aversion in a Reward context, comes in the form of reverse pay-for-performance, which is based on the principle of loss aversion. Using this principle, incentive programmes (bonuses and sales commissions) are designed whereby incentives are paid upfront, with a requirement that the organisation can clawback the incentive payment should the performance goals be missed. Early indicators suggest that our aversion to loss is more powerful than the promise of gains, and that reverse pay-for-performance can work in the right circumstances.

Summary

Behavioural economics, nudges and all their various principles, applications and tools are a powerful force if used appropriately. Long-term effectiveness in organisations relies on these aspects of Behavioural Economics being used transparently, ethically and without malice. Behavioural economics should only be used for the good of the organisation and the individual, and Reward professionals need to be aware of both the positive and negative effects of applying behavioural economics and nudge theory when designing reward frameworks and incentive programmes.

Further reading:

Thaler, Richard Cass Sunstein. *Nudge: Improving Decisions About Health, Wealth, and Happiness* (Yale University Press, 2008)

Kahneman, Daniel. *Thinking, Fast and Slow* (New York: Farrar, Straus and Giroux, 2011)

Ariely, Dan. *Predictably Irrational: The Hidden Force That Shape Our Decisions* (Harper Collins, 2008)