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# Pay, promotions, and performance

van Herpen, M.F.M.

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# 8 MANAGERIAL SUMMARY AND IMPLICATIONS

Chapter 1 refers to the title of the prominent Baker and Holmstrom (1995) study "Internal Labor Markets: Too Many Theories, Too Few Facts" as a rationale for empirical essays on personnel economics. The main purpose of this dissertation is to add some facts to the many theories on this topic. These empirical facts not only add to economic science but they also have direct implications for practitioners and HR policies of large and medium-sized companies; on the basis of the discussions I had with various (HR) managers from the companies that were studied in Chapters 3 and 4 my studies address the practical issues that they experience. The goal of this chapter is to review the previously discussed theories and empirical findings from a managerial perspective.

Figure 8.1 builds on Figure 2.1 and shows the link between value creation, the performance of employees, and the two main characteristics of employees that drive their performance: *motivation* and *ability*. In what follows I will put the lessons learned from personnel economics regarding the relationship between motivation, ability, and (employee) performance in a managerial perspective on the basis of five questions that were raised throughout this dissertation. In each of the following sections one of these five questions will be addressed, first from a theoretical perspective, and then the practical implications will be drawn from each of the essays.

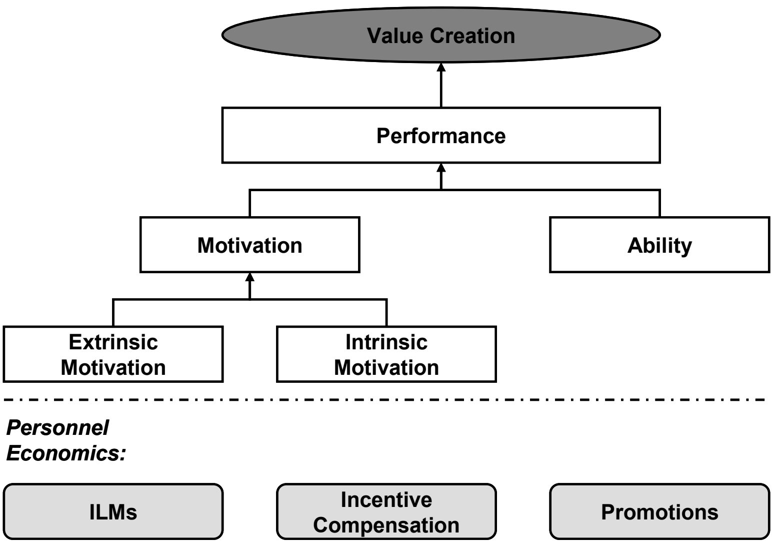


**Figure 8.1: Value creation from a human capital perspective**

## 8.1 Why Care about Intrinsic Motivation?

### *8.1.1 Theory*

In Figure 8.1, I distinguish two types of motivation: extrinsic motivation and intrinsic motivation. Extrinsic motivation refers to motivation induced by external interventions (Frey, 1997a) and works like quid pro quo: in exchange for external rewards (e.g. monetary compensation, praise by the boss, promotions or status), employees will deliver a certain performance. Intrinsic 'rewards' refer to the utility derived from performing a task for its own sake because it generates immediate need satisfaction. Agency theorists (see Section 2.2.1) have investigated how incentive compensation and promotions affect extrinsic motivation. In particular, tournament theory describes how promotions within the hierarchy of an organization can serve as an incentive device (see Section 2.2.2 for a theoretical discussion, and Section 2.2.4.3 for empirical evidence of this model).

Economists have mainly focused on the effects of extrinsic motivation. However, taking intrinsic motivation into consideration is also useful because intrinsic motivation can induce productivity as well. Moreover, in cognitive evaluation theory (see Section 2.2.3) psychologists have described how external interventions that positively affect extrinsic motivation can also (negatively) affect intrinsic motivation. This theory has made its way into economics (e.g. Bénabou and Tirole, 2003), and is typically labeled 'crowding theory' (Frey 1997a; Frey 1997b).

Crowding theory describes the "hidden" costs and benefits of rewards. On the one hand, employees can perceive an external intervention (for example, incentive compensation) to be controlling and leading to the "crowding-out" of intrinsic motivation. On the other hand, employees can appreciate the informing aspects of external interventions and monitoring, leading to "crowding-in" of intrinsic motivation. The overall effect on motivation is thus undetermined (see also Section 2.2.3) and depends on the nature of the external intervention. Although psychologists have extensively tested cognitive evaluation theory and some economists have also empirically investigated facets of crowding theory, the evidence is inconclusive (see Section 2.2.4.2). More investigations are required to conclude whether, and under what circumstances, it is important to take potential crowding effects into account when designing systems for either incentive compensation or promotions.

### *8.1.2 Implications from the various essays*

In Chapter 3, crowding theory is analyzed empirically. I find no evidence of a relationship between the perceived characteristics of the monetary part of the compensation system and intrinsic motivation. Crowding theory predicts that a compensation system that is perceived as controlling can decrease (crowd out) intrinsic motivation, while an informing compensation system increases (crowds in) intrinsic motivation. I find no evidence that either type of crowding takes place as far as monetary compensation is concerned. It is not possible to extend this conclusion to incentive compensation based on the evidence in Chapter 3 because only a small number of employees studied received variable pay.

I also investigate the relationship between promotions and motivation (see Chapters 3 and 4). First, it is shown that the prospect of a promotion increases extrinsic motivation (see Chapter 4). This is comparable to the way incentive systems are expected to work: the prospect of monetary compensation as a result of good performance leads to an increase in extrinsic motivation. Still, the overall incentive effect of promotions is not identical to the incentive effect of performance-based compensation. Contrary to incentive pay, promotions are also related to intrinsic motivation, not just extrinsic motivation. Whereas Chapter 3 showed no evidence of a relationship between monetary compensation and intrinsic motivation, Chapter 4 demonstrated that the level of intrinsic motivation increases after an employee has been promoted. An explanation for this observation is that the new job provides job challenges and new immediate need satisfaction. This additional incentive effect underlines the importance of promotions to motivate employees.

I conclude that it is important to take intrinsic motivation into account when designing incentive systems and deciding between incentive compensation and promotions. Each instrument has distinct effects on intrinsic and extrinsic motivation. For example, if a company was relying on promotions as an incentive device and for some reason has to abandon this strategy (e.g. less promotion opportunities within the organizations due to low growth rates, as discussed in Section 8.3), incentive compensation is an alternative to keep workers extrinsically motivated. However, other instruments have to be applied as well in order to at least maintain the old level of intrinsic motivation. Examples are job enrichment or job rotation (horizontal 'promotions').

## 8.2 How Does the Design of a Compensation System Impact the Motivation of Employees?

### *8.2.1 Theory*

In this section I focus on the quality of the design of the compensation system,[116] again distinguishing incentive compensation and promotions. I will first review the three main elements (see Figure 8.2) of both instruments and then discuss the design criteria.

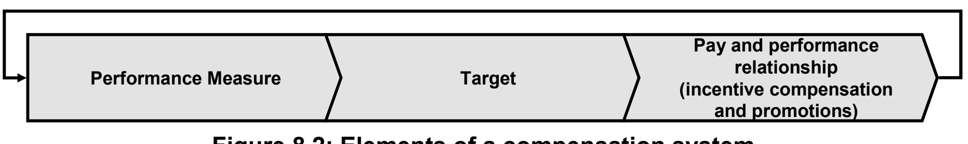


**Figure 8.2: Elements of a compensation system**

#### *8.2.1.1 Elements of incentive compensation*

The first element of the incentive compensation system is the performance measure used in the incentive contract. In principle, every indicator that contains information about the performance of the worker(s) can be used as a performance measure. Examples are measures that focus on the company as a whole, such as the stock price of the company, the absolute amount of profit, or the profitability (profit as a percentage of the total sales or of the amount of capital employed). In addition, measures focusing on the productivity of an individual employee can be used (the amount of time worked or the number of products produced). In addition to quantitative measures, qualitative measures, such as customer satisfaction, leadership or cooperation with colleagues, can also be used.

[116] Throughout this dissertation I define a 'compensation system' as the complete package of monetary fixed compensation, incentive compensation and promotions.

Once the appropriate performance measures are selected, as a second element the organization often expresses a minimum expected performance (standard). On top of that, a target is used to express a goal: a desired level of performance that motivates the employees to exert themselves. Theory on job challenge indicates that motivation will be highest if the targets are challenging but realistic (see Section 2.2.3). Targets are based either on historical performance or on performance relative to a benchmark (e.g. competitors). In many circumstances, a benchmark or relative target is the preferred option of these two, in order to decrease the risk inherent in an absolute performance measure (see Section 8.2.1.3 for a discussion of problems that can arise with incentive compensation in general and targets in particular).[117] It is important to keep in mind, however, that targets are *not a necessary element* of an incentive compensation system.

The third element is the pay-performance relationship. Figure 8.3 depicts three examples of commonly used payment schemes. The first two graphs (Figures 8.3 a, b) show a linear pay-performance relationship where no targets are used. In the first graph (a), the employee obtains a fixed amount of pay at zero performance, while additional performance increases the pay level linearly. The second graph (b) also depicts a linear pay-performance relationship, but this time with an incentive zone, hence making use of a target. No bonus is paid on top of the fixed pay below the minimum required performance level, while performance beyond the maximum will lead to no bonus increases either. In this way, companies limit the maximum wage payments and indicate which performance is acceptable and which is not. The angle (β) in the pay-performance relationship (Figures 8.3 a, b) represents the incentive intensity. The theory behind deciding which performance measure to include and the incentive intensity in the pay-performance relationship (β) will be discussed in Section 8.2.1.3. The last graph (c) shows a pay-performance relationship, where the extra payout is directly dependent on meeting the target. It is important to note that in graphs (b) and (c) no incentives are provided when the performance exceeds the maximum. Similarly, the incentive contract will not motivate an employee who knows the minimum required performance is not feasible.

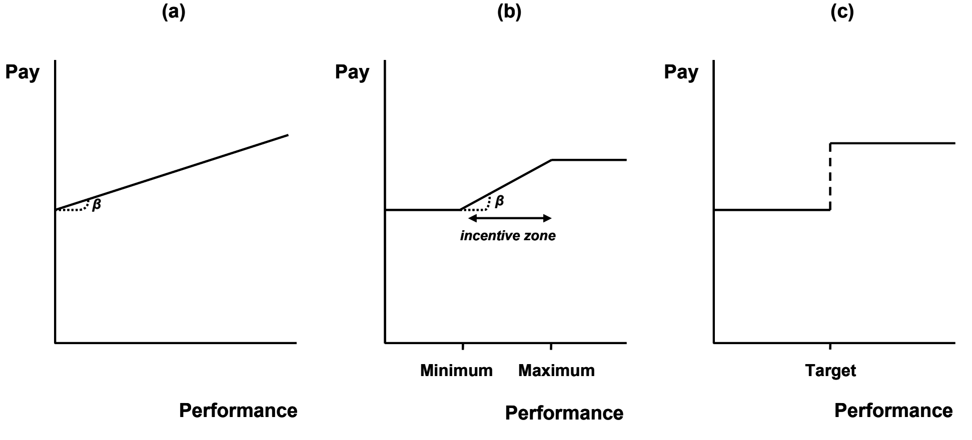


**Figure 8.3: Examples of pay and performance relationships**

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[117] For example, let us consider an ice-cream seller who is rewarded on the basis of the number of ice creams he sells on a beach. His revenue will depend on his effort (e.g. customer contact, the number of kilometers he covers on the beach a day), but even more so on the weather. A relative performance measure, for example the number of ice-creams sold relative to overall ice-cream sales on that day, will eliminate the influence of weather.

#### 8.2.1.2 Elements of promotions

A promotion-based incentive system is typically characterized by the absence of a formal contract. Usually, workers do not have a written form stating the measures on which their performance will be evaluated and what levels of performance will lead to a promotion. The promotion is awarded based on the basis of a subjective evaluation of the performance made by the supervisor(s), while the performance measures are typically not clearly communicated to the workers in advance.

In a promotion-based incentive system, the target is to perform better than your co-workers, i.e. relative performance evaluation. This implies that a performance standard is not quantified in advance.[118] A promotion pays out in many different forms. A direct monetary effect of a promotion is the salary increase that usually accompanies the promotion.
But the effects of a promotion are potentially much greater than this immediate increase in fixed salary. A promotion offers the possibility to participate in future rounds of the tournament. The prospect of future promotions has a financial option value that needs to be taken into account as well.[119] The non-monetary beneficial effects of a promotion are the challenge of a new job and the opportunities for further development and personal growth, which can be valued highly by the workers (see Chapter 4). In addition, the status that comes with the new job title can be important. Finally, a promotion is a signal to the outside world about the ability of the worker, thereby increasing the market value of the employee.

#### 8.2.1.3 Design criteria

Most difficulties surrounding the design of a compensation system in general, and of the selection of performance measures in particular can be traced back to the fundamental tradeoff between *risk* and *distortion* (see Baker, 2002, and also Section 3.2.1). Distortion refers (inversely) to the degree to which a performance measure is aligned with the firm's objectives. Risk relates to the uncertainty that workers experience (that is: will effort actually lead to highly measured performance and thus rewards?).

An undistorted measure is a measure that accurately captures value-creating behavior and is thus completely aligned with the shareholders' interests. Such an undistorted measure is rare; most performance measures also include undesired performance outcomes that are not in line with overall value-creation. For example, workers can resort to *gaming*. Gaming reflects behavior that is conducted to maneuver the output in such a way that the scores on the performance measures are high, while in fact the underlying performance is not in the best interest of the principal (distorted). Examples of gaming are found in Baker et al. (1994) and sometimes illustrate the thin line between distorted performance and fraud.[120]
Distortion also refers to *multi-tasking problems*. This type of problems occurs when the performance measures do not capture the complete variety of tasks, and workers allocate their time disproportionately to measured tasks that are rewarded, such that it is sub-optimal from the principal's perspective. Tasks, which are not compensated by the incentive contract, and to which costs of effort are attached, will be neglected. A famous 1975 study by Steven Kerr has the apt title "On the folly of rewarding A,

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[118] This refers to the basic form of promotion system. Outsiders can participate as well, and also up-or-out promotion systems exist, which reward employees on the basis of absolute performance instead of relative (see Section 8.4).

[119] I have determined the direct effect of a promotion on wages to be 5 percent and estimated the lifetime wage growth on average to depend for approximately 25 percent on promotions (see Chapter 4).

[120] See also Cools (2005).

while hoping for B". The title nicely captures that the behavior that is rewarded is not necessarily the desired behavior, resulting in a distorted compensation system.

The other component of the tradeoff is risk. Incentive compensation involves risk for the workers, which is caused by external factors that, besides the worker's effort, determine the performance. For example, using the share price of a company as a performance measure will introduce uncontrollable elements in the measure, such as the general economic climate and the sentiment on the stock market (see also footnote 117).

An undistorted and risk-free performance measure does not exist. Measures that are available do to some extent meet either of these two characteristics. Organizations have to rely on second-best measures that trade off risk and distortion. The degree to which it is possible to select performance measures that are undistorted and involve low risk for the workers determines the incentive intensity (i.e. the $\beta$ in the pay-performance relationship).

The economist's concept of risk is somewhat intangible and hard to capture when designing a compensation system. Psychologists have investigated related criteria and offer a more holistic approach. Thierry (1987) identifies three perceived characteristics of a compensation system: namely, (1) *controllability,* (2) *transparency* and (3) *fairness*, which determine its effectiveness (Langedijk and Ykema-Weinen, 2000). Controllability is the extent to which the employee is able to control the measured performance and thus payment, and captures the notion of risk best. Transparency can also be linked to risk. A compensation system that is not transparent includes uncertainty for the employee. I define a transparent compensation system in Chapter 3 as 'a compensation system that is not complex and is well communicated to the employees'.

Besides the two characteristics, controllability and transparency, which are related to risk, psychologists also emphasize the importance of fairness, which is not included in the risk and distortion tradeoff. A compensation system can be perceived as being fair with respect to two criteria. First of all, the surplus of high performance is shared between the owner of the firm and the worker who has contributed to the performance (according to reciprocity theory). Second, the perception of fairness can be sustained by giving higher rewards to those workers who have performed better. This type of differentiation in pay is central in equity theory.

### *8.2.2 Implications from the essays*

The theoretical discussion has, among other things, distinguished different elements of the compensation system and three design criteria (transparency, controllability, and fairness) in order to evaluate the effectiveness of the combination of these elements. In Chapter 3 I have investigated their relationship. As mentioned earlier, I found no relationship between the quality of the design of the monetary part of the compensation system (as perceived by the employees) and intrinsic motivation. I did find that the perceptions of fairness and controllability of the monetary part of the compensation system are positively related to extrinsic motivation (see Chapter 3). Even more so, fairness is positively related to work satisfaction and negatively related to turnover intention.

Chapters 3 and 4 showed how unfairness can manifest itself in practice. I found that the selection of performance measures and the evaluation practice of incentive compensation is not always well developed, and managers have a tendency to evade the evaluation of workers. The result of shirking by managers is manifested in the distribution of evaluation scores. Two famous patterns are *compression* and *inflation* (i.e. regression to the top scores).[121] The result will be an unfair compensation system (workers with high performance do not receive relatively higher pay), which offers no incentives or even disincentives.

Alternatively, promotions can be used as an incentive instrument, indicated by the positive effect of promotions on motivation (see Chapter 4). The perception of fairness of the promotion process has a significant positive relationship with extrinsic motivation. At the same time, transparency and controllability are positively related to extrinsic motivation, to intrinsic motivation, and to work satisfaction (see Chapter 3). It thus especially pays to devote time and effort to create transparent and controllable promotion opportunities. Clear communication about which opportunities exist and which criteria are used in the evaluation process will improve the controllability and transparency of a promotion based incentive system. Overall, whereas fairness is an important design criterion for incentive compensation, a focus on clear communication is important to enhance the incentive effects of promotions.

In sum, the empirical results have shown a strong relationship between the perceived design of the compensation system and motivation. The conclusion that promotions are not only related to extrinsic motivation but also to intrinsic motivation makes it important to investigate in which situations internal job movements are a reasonable option as an incentive device, and, alternatively, when other incentive devices have to be employed.

## 8.3 What Is an Internal Labor Market and Where Is It Used?

### *8.3.1 Theory*

An internal labor market (ILM) encompasses employment practices and policies governed by administrative rules (Doeringer and Piore, 1971). Personnel economists interpret the concept of ILMs as a system that organizations install to internally organize career paths and wage policies in such a way that these can provide incentives (Eriksson and Werwatz, 2003). An ILM shields workers from the influences of the external labor market, but still the internal and the external labor markets always interact with each other to some extent; workers can follow careers within an organization, but they can also explore external job opportunities. And conversely, for any job opening, the possibility almost always exists that it will be filled by an outside worker. It is thus not reasonable to state that some firms have an ILM, while others do not: an ILM is always present, although it can be less dominant in some organizations relative to others. A clear example of an organization where the ILM has a strong and clear presence is the military. All characteristics are present: long-term employment relationships, where new workers are usually hired at the bottom level of the organization and have a clear career path in front of them.

The procedural elements of the ILM are: the recruiting phase, the retention phase in which workers are internally sorted and their skills are being developed, and, finally, separation ends the employment relationship (see Figure 8.4).

[121] Table 4.4 shows evidence of compression.

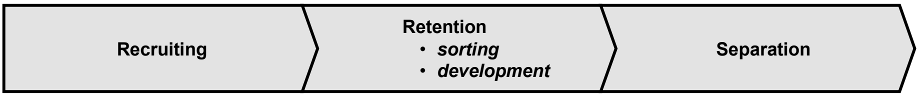


**Figure 8.4: Recruiting, retention, and separation**

The first element of the ILM is recruiting. New workers are attracted by the job itself and the complete compensation package that is offered to them, as well as by the career path the firm is likely to offer to them. The attractiveness of the job itself is described in job-matching theory (see Section 2.3.2). The generally accepted definition of job-matching relates to the extent to which the ability of the worker matches the tasks in a job. A job with a worse (better) match will require more (less) effort from the worker in order to generate the same level of output. The compensation system, as specified by the administrative rules of the ILM, will also be used to attract a worker. Workers will look for organizations that reward their specific ability, now and in the future.

The second element of the ILM is the retention of employees. An organization can use its wage policy and internal hierarchy to motivate and retain its workers. First of all, the wage level can be deployed to ensure retention. “Efficiency wages” is a technique where above market-clearing wages are offered to enhance loyalty. A second technique is to create an age-wage profile that offers high (i.e. higher than marginal productivity) wages for employees with more tenure and low (i.e. lower than marginal productivity) wages for employees with less tenure. (Young) employees with less tenure will be bound to a company and exert effort due the prospect of high future wages. More generally, offering promotion opportunities and thereby wage growth within a firm is a third technique to retain employees.[122]

Workers who spend their entire career at a single organization are rare. Often the external labor market is explored in order to find suitable job openings elsewhere, either on workers’ initiative (see job search theory, Section 2.3.2), or after the employer decides to discontinue the contract. The definition of the ILM states that specific ports of exit exist where workers leave an organization.[123] This is the third element of the ILM. It is important to note that turnover offers advantages to incumbent employees. For example, turnover at the top level of the organization will cascade promotion opportunities down the organization. The result is paradoxical: an increase in separations (and thus interactions with the external labor market) will clear career paths and increase the internal mobility.

### *8.3.2 Implications from the essays*

Before discussing the motives and risks of internal mobility (Section 8.4), I first would like to describe the characteristics of those organizations with higher levels of internal mobility. On the basis of empirical studies within personnel economics, I distill four determinants: organizational size, growth rate, profitability level, and industry. In Chapter 5 I empirically explore the effects of these four determinants on the use of the ILM, thereby showing

[122] Theoretical descriptions of retention tools (e.g. age-wage profiles and efficiency wages), as well as more managerial-oriented literature, are numerous and are not explored in detail in this dissertation.

[123] The theoretical notion of specific ports of exit is not unambiguously supported by empirical evidence. Evidence shows that workers leave organizations at all hierarchical levels.

which types of organizations tend to make relatively more use of internal mobility (and those organizations that do not).

In general, large, profitable and growing companies are more able to organize internal career moves (Chapter 5). Small, unprofitable and shrinking organizations tend to interact more extensively with the external labor market. Unprofitable firms have higher levels of turnover throughout the organization, but especially at the top-management level. Such organizations have a higher probability to hire outside managers at a higher wage level. A possible explanation is that they prefer better and more experienced managers to deal with the problematic (financial) situation. In contrast, profitable firms prefer homegrown top-managers. In addition, larger organizations have relatively less inflow at the top of the organization. The third of these criteria , the growth rate of the organization, is also highly related to where employees enter the organization. Fast-growing organizations hire relatively more workers at the lower ranks relative to slower growing/shrinking organizations, indicating that these firms are more able to organize internal job movements.

The identification of these determinants indicates that not all firms are equally likely to organize internal job movements. The next section will explore why this is so.

## 8.4 What Are the Motives and Risks of Internal Mobility?

### *8.4.1 Theory*

While the previous section describes the elements of the ILM, this section will turn to the raison d'être of the ILM. Table 8.1 presents the motives and risks of making use of internal mobility.

**Table 8.1: Motives and risks of internal mobility**

| | **Motives for internal mobility** | **Risks of internal mobility** |
|---|---|---|
| *Perspective of the firm* | *• Investments in firm-specific human capital*<br>*• Limiting recruiting costs*<br>*• Learning about ability*<br>*• Incentive effects of promotions (specific case of up-or-out promotions)* | *• Inefficient relocations*<br>*• Peter principle*<br>*• Golden handcuffs*<br>*• Inertia* |
| *Perspective of the worker* | *• Reward for firm-specific human capital*<br>*• Job security*<br>*• Limiting search costs* | *• Breach of contract and thereby loss of investments in specific human capital*<br>*• Inertia* |

The first motive in favor of internal mobility is specified in human capital theory (Section 2.3.1). Human capital is accumulated over time, by means of, among other things, (job) experience. Human capital theory distinguishes two types of human capital: general and firm-specific human capital. General human capital can be transferred to other firms. Firm-specific human capital refers to abilities that are of no value to other firms, but are only valuable to the incumbent firm. For example, some skills that soldiers learn in the military are 'firm-' specific and not relevant for the outside job market. Turnover will make this type of human capital worthless. Therefore, employees are only willing to invest in firm-specific human capital if parts of the rents will accrue to them. An ILM is a way of rewarding investments in firm-specific skills, tying workers to the organization. Whenever firm-specific human capital is an important input in the firm's production function, internal career prospects become a way to ensure this type of investments.

The advantages for employees to work for an organization that offers the prospect of long tenure tracks include job security and limited search costs for new jobs (i.e. time spent on exploring the external job market). A risk for employees is that a breach of the contract (involuntary turnover) will lead to the loss of firm-specific human capital. Therefore, it is important that the firm has a reputation of making credible promises to its employees regarding future rewards. Increasing the risk of dismissal (e.g. restructuring after an acquisition, strategic reorganization) will make investments in firm-specific human capital less probable.

From a firm perspective, limited turnover will reduce the costs of hiring personnel. These costs are not limited to the direct costs of the recruiting process, but include indirect costs too. Companies learn about the abilities of their employees over time (see the experience model as described in Section 2.3.2), which enables them to sort workers into the job that best suits them. An ILM thus shields firms against turnover that leads to a loss of knowledge about workers' abilities. At the same time this poses a risk for the firm. For example, a division manager can learn over time about the inability of a certain worker. Unwilling to fire the worker and send a message to other employees that job security is not guaranteed, the worker can be 'promoted' to a different department or division to become someone else's problem. This is clearly an example of an adverse side effect of an ILM.

Sections 8.1 and 8.2 showed an important motive for internal mobility: internal job opportunities provide incentives. It becomes apparent that promotions have a dual role: internal job movements are used both to sort employees according to their ability[124] and to increase effort (see the distinction between effort and ability in Figure 8.1). Using a single instrument simultaneously for two goals can lead to a predicament, known as *the Peter principle,* which states that workers are often promoted to their level of incompetence. Rewarding employees who are doing their current job well by means of a promotion, implies that the organization runs the risk of trading off the other attribute: namely, sorting employees and finding the job that fits them best.

A specific promotion-based incentive system is known as the up-or-out policy. Employees are specifically evaluated based on abilities required for the next hierarchical level. Whenever employees do not learn these skills within a specified amount of time communicated beforehand, these workers are required to leave the organization. The goal of this system is to motivate employees to invest in learning the required skills. A positive side effect is that the risk of the Peter principle is diminished. The flip-side is that even those workers who perform adequately at the original hierarchical level are also asked to leave. In such a system matching is thus seen as less important than providing incentives.

An additional pitfall of internal mobility is that organizations can use "golden handcuffs" to tie employees to the organization. This is a direct result of the retention instruments. For example, in companies with a steep age-wage profile, employees with long tenure have high levels of fixed compensation. The same holds for companies using efficiency wages. In an Anglo-Saxon environment, the risk of being fired and falling back to the market clearing wage level (career concerns) will keep these employees motivated to

[124] Sorting employees based on ability is a way to motivate employees to invest in firm-specific human capital.

perform. In the Netherlands, Dutch labor laws protect workers in such a way that the risk of dismissal is diminished. As a result, employees can be demotivated (e.g. if they are doing the same job for a long period[125]) but they do not voluntarily leave their organization since the external labor market offers them a wage cut.[126] The result is that "golden handcuffs" limit mobility and actually start to work as a disadvantage for the organization.

### *8.4.2 Implications from the essays*

Table 8.1 mentions an additional risk of internal mobility, inertia, which was explored in Chapter 6. Organizations require continuous learning, especially in a changing environment. Companies with a preference for using the ILM as a pool of fulfilling job openings make an organization run the risk of inertia since few outsiders can enter the organization to introduce new ideas.[127] Hiring new workers is a way to escape so-called mental prisons. Workers who switch organizations bring previously learned skills that benefit the capabilities of the organization. Moreover, working at a single firm for a long period will pose a risk for employees. Locked in a single corporate culture, while often performing the same tasks, makes them less attractive candidates for outside jobs as opposed to workers who are more flexible and can more easily adjust to new jobs. I show empirically that having multiple previous jobs benefits the wage level of employees throughout their career. This indicates that employers value work experience that workers have acquired outside their current place of employment.

Overall, the decision whether to use internal mobility extensively is based on a tradeoff between all above-mentioned motives and risks, including the proven risk of inertia.

## 8.5 How Is It Possible to Trade Off the Use of Incentive Compensation and Promotions as an Incentive Device?

This section integrates and summarizes the previous questions. I will briefly recapitulate the main theoretical motives of incentive compensation and promotions after which Questions 8.1 – 8.4 will be summarized. I will end with a policy implication.

### *8.5.1 Theory*

Let us take a step back and review the basic arguments in favor of incentive compensation and promotions. The most important goal of performance-based pay, i.e. incentive compensation, is to increase performance (see Sections 8.1 and 8.2). Some empirical research has shown that, especially for lower-level workers, performance will increase after introducing incentive compensation due to two factors (see also Section 2.2.4.1): productivity and selectivity (see Lazear, 2000b). Incumbent employees will work harder (incentive effect). Less able workers will leave a company since the pay-performance

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[125] Chapter 5 showed how the absence of changes in job will diminish intrinsic motivation.

[126] The absence of organizational growth will potentially result in companies that have highly paid workers who are unwilling to leave the company voluntarily and are obstructing the career path of other employees. Chapter 3 describes an organization where the administrative governance of the ILM has led to a situation of highly paid individuals clogging the career tracks.

[127] Chapter 6 indicates in what way companies and workers can both benefit from the separation of workers.

relationship is not beneficial for them, while more able workers are attracted (selectivity). Lazear (2000b) shows that the introduction of a piece-rate system in a car glass company increases output by 44 percent; half of it is caused by increased productivity, and half of it by a more competent workforce. A third positive attribute of incentive compensation is that it is an instrument to communicate organizational goals to employees. The type of performance measure, the standard, target and the pay-performance relationship of incentive compensation all serve to communicate the type of performance that is valued (see Section 8.2.1).

Promotions are a way to internally sort employees. This can be viewed as an alternative to the self-selection effect of incentive compensation: workers are attracted at the bottom level and sorted based on their performance as they move up in the hierarchy. Promotions are also expected to motivate employees. The arguments in favor of incentive compensation, i.e. the motivational aspect and the selectivity of employees, in theory also hold for promotions.

### *8.5.2 Implications from the essays*

Section 8.5.1 briefly discussed the relative benefits and costs attached to incentive compensation, on the one hand, and promotions, on the other hand. In this dissertation I investigate additional considerations and bring new evidence on how ILMs, promotions and incentive compensation are associated.

- Question 8.1: Why care about intrinsic motivation?

  The relationship between incentive compensation and motivation is fundamentally different from the relationship between promotions and motivation. On the one hand, a well-designed monetary compensation system is positively related to extrinsic motivation, but I have found no relationship between monetary compensation and intrinsic motivation (see the results in Chapter 3), in line with ambiguous results in previous empirical research (see the discussion in Section 2.2.4.2). On the other hand, promotions do not only affect extrinsic motivation ex ante but are also related to intrinsic motivation. Thus, a well-designed incentive compensation system could positively impact extrinsic motivation, while promotions will increase both extrinsic motivation (ex-ante) and intrinsic motivation (foremost ex-post) (see the results in Chapter 4).

- Question 8.2: How does the design of a compensation system impact the motivation of employees?

  Overall, the design criteria for incentive compensation and promotions are similar. In Chapter 3 I distinguished perceived fairness, transparency, and controllability as three main design criteria. These perceptions define the quality of a compensation system from the employee perspective. The results of Chapter 3 showed the importance of these perceptions.

- Question 8.3: What is an internal labor market and where is it used?

  I have also investigated new determinants of the usage of internal promotion opportunities as an incentive device (Section 8.3). Large, fast-growing, and profitable organizations are more likely to offer an internal career track to their workers (see Chapter 5), while using an internal career track as an incentive instrument is less suitable for small, shrinking, and unprofitable firms.

- Question 8.4: What are the motives and risks of internal mobility?

  A limitation of internal mobility was introduced in Section 8.4. If a company focuses on developing employees internally, the firm can move into a period of inertia. Incumbent employees will block external recruitment, necessary to revive the organization and introduce new types of human capital. Thus, besides fulfilling job openings from the inside, since this motivates incumbents, it can also be valuable to recruit from the outside (see the results in Chapter 6).

Overall, I have introduced additional facts that need to be accounted for when trading off the use of incentive compensation and promotions as an incentive device. Promotions are an attractive incentive device with a positive effect on intrinsic motivation after the promotion has taken place. However, some firms (small, unprofitable firms that lack growth) might be unable to continue to offer career tracks to their employees. For these firms in particular it remains important to keep refreshing the organization with outsiders.

The conclusions provide a policy implication. In order to create enough room for both internal *and* external job movements it can be necessary to resort to involuntary turnover. In the Netherlands, legislation is focused on defending the status of the incumbent workers. The result is that organizations are unable to create job openings by firing workers. If they were able to lay off workers more easily, room would be generated to promote more workers from the inside, which cascades promotions down the organization. Furthermore, it could be necessary to fill some positions from the outside in order to refresh the human capital in the organization. Although many other arguments exist, these results emphasize the importance for policy makers, especially in the Netherlands, to aim at a flexible labor market that offers sufficient development opportunities for all workers and does not only protect workers from involuntary turnover.