

COURSE: REWARD MANAGEMENT

LECTURE 5: FINANACIAL REWARDS

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Lecture learning outcomes:

At the end of the lecture, you will be able to:

- a) Understand the concept of financial rewards**
- b) Discuss the role of money**
- c) Examine factors affecting financial rewards**
- d) Discuss the criteria for financial rewards**

FINANCIAL REWARDS

Financial rewards comprise all rewards that have a monetary value and add up to total remuneration – base pay, pay contingent on performance, contribution, competency or skill, pay related to service, financial recognition schemes, and benefits such as pensions, sick pay and health insurance. The management of a reward system requires decisions on levels of pay, how jobs should be valued, the design and operation of grade and pay structures and the choice of benefits. Such decisions can be complex and difficult, but the problems pale by comparison with the issues surrounding the use of financial rewards contingent on performance, contribution and competence or skill.

Rewards offer tangible recognition to people for their achievements and contribution. Financial rewards consist of job-based pay, which provides base pay related to the value of the job, and person-based pay, which provides rewards that recognize the individual's contribution, competence, or skill. Rewards can also be non-financial, for example recognition. If rewards are worth having and attainable and people know how they can attain them, they can act as motivators.

Incentives are intended to encourage people to work harder and achieve more. They are supposed to provide direct motivation: 'Do this and we will make it worth your while.' Incentives are generally financial but they can take the form of non-financial rewards such as promotion or a particularly interesting assignment.

Money and motivation

It is reasonable to assume that people need money and therefore want money, but the question is: How well does it perform as a motivator? It has been suggested by Wallace and Szilagyi (1982) that money can serve the following reward functions:

- It can act as a goal that people generally strive for, although to different degrees.
- It can act as an instrument that provides valued outcomes.
- It can be a symbol that indicates the recipient's value to the organization.

- It can act as a general reinforcer because it is associated with valued rewards and therefore takes on reward value itself.

Money can motivate because it is linked directly or indirectly with the satisfaction of many needs. It satisfies the basic need for survival and security, if income is regular.

It can also satisfy the need for self-esteem (it is a visible mark of appreciation) and status – money can set you in a grade apart from your fellows and can buy you things they cannot afford.

Money satisfies the less desirable but nevertheless prevalent drives of acquisitiveness and cupidity.

So money may in itself have no intrinsic meaning, but it acquires motivating power because it comes to symbolize so many intangible goals. It acts as a symbol in different ways for different people, and for the same person at different times. Pay is often a dominant factor in the choice of employer and is an important consideration when people are deciding whether or not to stay with an organization. Money can indeed motivate but it is not the only motivator. As Gerhart and Rynes (2003) comment: ‘Although we see little evidence to support the notion that money is of secondary importance as a motivator, there is nevertheless ample evidence that money is not the only reward that motivates.’

However, according to Herzberg (1968) money does not result in lasting satisfaction. People may feel good when they get an increase as, apart from the extra money, it is a way of making people feel they are valued. But the feeling of euphoria can die away and it must be re-emphasized that different people have different needs. Some will be much more motivated by money than others. What cannot be assumed is that money motivates everyone in the same way and to the same extent.

To believe that financial incentives will always motivate people to perform better is as simplistic as to assume, like Kohn, that they never motivate people to perform better. Some people will be more motivated by money than others and, if handled properly, an incentive scheme in the right context can encourage them to perform more effectively as long as they can link their effort to the reward and the reward is worth having. But others may be less interested in money and will respond more to intrinsic or non-financial rewards. It can be argued in accordance with total rewards philosophy that most people are likely to react positively to a judicious mix of both financial and non-financial rewards.

What is clear is that simplistic assumptions about the power of money to motivate can lead organizations into developing simplistic performance-related pay schemes or other forms of incentives. And we can be sure that a multiplicity of interdependent factors are involved in motivating people. Money is only one of those factors that may work for some people in some circumstances but may not work for other people in other circumstances.

It should also be remembered that while an increase in pay arising from a contingent pay scheme may motivate people who get it, for a limited period perhaps, it may well demotivate those who don't get it or feel that they are not getting enough compared with other people. The number of people demotivated in this way could be larger than the number who have been motivated. Paradoxically, therefore, contingent pay schemes are in danger of increasing the amount of demotivation existing in the organization rather than enhancing motivation.

Factors affecting satisfaction with pay

Lawler (1990) points out, people's feelings about the adequacy of their pay are based upon comparisons they make between their own and others'. External market comparisons are the most critical because they are the ones that strongly influence whether individuals want to stay with the organization. Many people, however, are unlikely to leave for pay reasons alone unless the increase they expect from a move is substantial, say 10 per cent.

Lawler also comments: 'Sometimes it seems that individuals are never satisfied with the pay.' One of the reasons suggested by Lawler for low pay satisfaction seems to be that individuals seek out unfavorable comparisons. First, they look externally: if comparisons there are favorable, they focus on internal comparisons. Only if these are favorable as well are they likely to be satisfied. He states that: 'A finding that employees are dissatisfied with pay is, in effect, a non-finding. It is to be expected. The key thing that the organization needs to focus on is whether its employees are more dissatisfied with their pay than are employees in other organizations.'

Reactions to reward policies and practices will depend largely on the values and needs of individuals and on their employment conditions. It is therefore dangerous to generalize about the causes of satisfaction or dissatisfaction. However, it seems reasonable to believe that, as mentioned above, feelings about external and internal equity (the 'felt fair' principle as defined by Jaques, 1961) will strongly influence most people. Research by Porter and Lawler (1968) has also shown that higher-paid employees are likely to be more satisfied with their rewards but the satisfaction resulting from a large pay increase may be short-lived. People tend to want more of the same.

Other factors which may affect satisfaction or dissatisfaction with pay include the degree to which:

- individuals feel their rate of pay or increase has been determined fairly (the principle of procedural justice)
- rewards are commensurate with the perceptions of individuals about their ability, contribution and value to the organization founded on information or beliefs about what other people, inside and outside the organization, are paid (the principle of distributive justice)
- individuals are satisfied with other aspects of their employment – for example, the quality of working life, work–life balance, their status, promotion prospects, opportunity to use and develop skills, and relations with their managers and colleague

Job satisfaction and performance

Pay may increase job satisfaction but does job satisfaction improve performance? It is a commonly held and a seemingly not unreasonable belief that it does. But research has not established any strongly positive connection between satisfaction and performance. A review of the extensive literature on this subject by Brayfield and Crockett (1955) concluded that there was little evidence of any simple or appreciable relationship between employee satisfaction and performance. An updated review of their analysis by Vroom (1964) covered 20 studies, in each of which one or more measures of job satisfaction or employee attitudes was correlated with one or more criteria

of performance. The median correlation of all these studies was 0.14, which is not high enough to suggest a marked relationship between satisfaction and performance.

It can be argued that it is not job satisfaction that produces high performance but high performance that produces job satisfaction, and that a satisfied worker is not necessarily a productive worker and a high producer is not necessarily a satisfied worker. People are motivated to achieve certain goals and will be satisfied if they achieve these goals through improved performance. They may be even more satisfied if they are then rewarded by extrinsic recognition or an intrinsic sense of achievement. It can also be argued that some people may be complacently satisfied with their job and will not be inspired to work harder or better. They may find other ways to satisfy their needs.

Research on the effectiveness of financial reward

Much research has been conducted on the effectiveness of financial rewards in terms of their impact on people and performance.

Kessler and Purcell (1992)

Research into individual performance-related pay (PRP) was conducted over a three-year period in nine private and public sector organizations of varying sizes and operating in different product and labour markets. Material was also gained from interviews with over 60 senior and management figures. The main findings and conclusions were that:

- PRP was seen as a means of targeting pay to those who most deserve it and thus provides better value for money than inflexible, less discriminatory increases related to cost of living or service.
- Managements often experienced difficulties in operating the scheme because of the lack of formal supporting systems, absence of prior management training and the highly subjective nature of assessments.
- The potential for distorting the system is perhaps at its greatest at the assessment stage.
- PRP depends on 'sending messages' to individual members of staff but this entails the risk of sending the wrong messages.

At the crudest of levels, PRP schemes are informed by the view that employees will be motivated if they perceive a direct relationship between effort and reward. Such a view is simplistic for a number of reasons. First, as a means of explaining employee behaviour it clearly has limited value, with a whole body of research stressing the importance of employee expectations and need in understanding motivation. Second, it is highly questionable whether employee expectations of the performance–reward link underlying this motivational approach can remain undistorted by ongoing social, political and economic workplace pressures influencing the operation of this pay system. Third, and perhaps most significant, it misses the point because many senior managers are skeptical of such a link themselves and do not necessarily claim any major impact in this particular respect.

- The amount of money available may be too small to make any impact.

- The sophisticated procedures and systems needed and their application by managers present a range of difficulties to the achievement of recruitment, retention and motivation.
- ‘There are major difficulties in finding measures of PRP effectiveness. The bottom line measure of effectiveness for any payment system is arguably an improvement in overall organizational performance, assumed to flow from improved employee performance. It is, however, clear that the complex range of factors interacting to determine organizational performance make it difficult to isolate the impact of a payment system alone.

Thompson (1992a)

Marc Thompson, then with the IMS (now the Institute for Employment Studies), investigated the employer’s experience of individual performance-related pay (IPRP) in 20 organizations in the public and private sectors. He found that:

- Employers did not know if their scheme was effective in raising productivity for the simple reason that they did not monitor schemes on this basis.
- Many companies did not think through the introduction of IPRP in a coherent manner.
- There was some indication that line managers were neither totally aware nor convinced of the appropriateness of IPRP – it was this issue that led to some of the most difficult problems in practice.
- There are two main problems with the operation of IPRP schemes: 1) the values of employers may conflict with the values of employees, and 2) tensions may arise from employers’ beliefs about employee motivation and behaviour.
- One employer commented: ‘It’s an act of faith really... we think things would be worse if we weren’t using it.’
- One of the few employers who had conducted a survey on perceptions of IPRP found that when it was first introduced, less than 20 per cent felt it motivated; changes in the scheme’s administration had seen this rise to over 60 per cent (just over 80 per cent felt that they were rated fairly)
- One of the most consistent problems encountered in studying the effects of performance pay is that of causality – attributing increases or decreases in productivity to the payment system rather than to other factors such as technology, changes in working practices or changes in the product market.

Research projects producing mainly positive results

Evidence is available from a number of academic studies that indicate that performance pay improves performance:

- Abowd (1990) showed that bonus payments based on economic or market measures could contribute to a strong economic return.
- Booth and Frank (1999) found through their analysis of UK data provided by the British Household Panel Survey that jobs with performance-related pay attracted workers of higher ability and induced workers to provide greater effort.

- Gupta and Shaw (1998) conducted a meta-analysis of 39 rigorously designed studies examining the effects of financial incentives on performance. A strong positive effect was found on performance quantity. Only six studies examined performance quality separately and a consistent relationship between incentives and quality was not found.
- Guzzo et al (1985) found through a meta-analysis that, when applied in the right way and in the right situations, incentives can have strongly positive effects on productivity.
- Heneman (1992) reviewed five studies that established a positive link between a merit pay system and performance.
- Jenkins et al (1998) said of their study that it ‘underscores the generalizable positive relationship between financial incentives and performance’.
- Lazear (1999) found that the productivity of operatives in a factory increased by 44 per cent following the introduction of a piece-rate incentive plan.
- Locke et al (1980) reviewed 44 studies on the adoption of incentive systems that showed in almost all cases a substantial improvement in performance.
- Marsden (2004) conducted a series of attitude surveys across a range of UK public services on employee and line manager judgements on the effects of performance pay. Performance pay was the instrument of a major renegotiation of performance norms, and this rather than motivation was the principal dynamic. Goal-setting and appraisal by line managers played a key role in this process.
- Prendergast (1999) reviewed the effect of incentives in both private and public sectors, leading to the conclusion that workers do respond to them.
- Prentice et al (2007) found that research indicated strong evidence that UK civil servants do respond to financial incentives.
- Stajkovic and Luthans (2001) showed that routine pay for performance increased performance over its baseline level by 11 per cent, while performance pay applied through the systematic procedures of the organizational behaviour model increased performance by 31.7 per cent.
- Sturman et al (2003) used utility analysis techniques to assess the costs and benefits of a contingent pay strategy. The conclusion was that the four-year benefit of linking pay to performance was substantial.
- Thompson (1998) in a study of 400 companies in the British aerospace industry established that the high-value-added and low-value-added companies were clearly differentiated in terms of their pay practices, with virtually double the number of high-value-added companies applying individual performance-related pay schemes to more than two-thirds of their staff.
- West et al (2005) conducted research in 15 customer service organizations into methods of rewarding customer service and found that in the five organizations superior to others in terms of customer service, 60 per cent had performance pay while in the other 10 only 29 per cent had performance pay.

Arguments for and against financial rewards

The concept of financial rewards in the shape of contingent pay has aroused strong feelings amongst those who support and those who oppose them.

Arguments for

The most powerful argument advanced for financial rewards is that those who contribute more should be paid more. It is right and proper to recognize achievement with a financial and therefore tangible reward. This is in accordance with the principle of distributive justice, which, while it states that rewards should be provided equitably, does not require them to be equal except when the value of contribution is equal.

Arguments against

The main arguments against financial rewards are that:

- The extent to which contingent pay schemes motivate is questionable – the amounts available for distribution are usually so small that they cannot act as an incentive.
- The requirements for success are exacting and difficult to achieve.
- Money by itself will not result in sustained motivation; intrinsic motivation provided by the work itself goes deeper and lasts longer.
- People react in widely different ways to any form of motivation – it cannot be assumed that money will motivate all people equally, yet that is the premise on which contingent pay schemes are based.
- Financial rewards may possibly motivate those who receive them but they can demotivate those that don't, and the numbers who are demotivated could be much higher than those who are motivated.
- Contingent pay schemes can create more dissatisfaction than satisfaction if they are perceived to be unfair, inadequate or badly managed.
- Employees can be suspicious of schemes because they fear that performance bars will be continuously raised; a scheme may therefore only operate successfully for a limited period.
- Schemes depend on the existence of accurate and reliable methods of measuring performance, contribution, competence or skill, which might not exist.
- Individuals are encouraged to emphasize only those aspects of performance that are rewarded

Contingent pay decisions depend on the judgement of managers, which in the absence of reliable criteria can be partial, prejudiced, inconsistent or ill-informed.

- The concept of contingent pay is based on the assumption that performance is completely under the control of individuals when in fact it is affected by the system in which they work.
- Contingent pay, especially performance-related pay, can militate against quality and teamwork.

As Thompson (1992a, 1992b) explained, the success of contingent pay rests largely in the hands of line managers. They have to believe in it as something that will help them as well as the organization. They must also be good at practicing the crucial skills of agreeing targets, measuring performance fairly and consistently, and providing feedback to their staff on the outcome of performance management and its impact on pay. Line managers can make or break contingent pay schemes. Vicky Wright (1991) summed it up: ‘Even the most ardent supporters of performance-related pay recognize that it is difficult to manage well,’ and Oliver (1996) made the point that ‘performance pay is beautiful in theory but difficult in practice.’

There is also the problem of moral hazard inherent in financial incentives. The concept of moral hazard originated in insurance, where it describes the phenomenon of people who because they are insulated from risk by being insured proceed to take unnecessary risks. The term was extended to incentives by Prendergast (1999), who pointed out that: ‘Contracts offering incentives can give rise to dysfunctional behaviour whereby agents emphasize only those objects of performance that are rewarded... Compensation on any sub-set of tasks will result in reallocation of activities towards those that are directly compensated and away from the uncompensated activities.’ A ‘moral hazard’ exists when incentive schemes encourage undesirable behaviour in which people strive to obtain higher rewards by manipulating results, hiding or even falsifying poor figures, focusing on easy short-term gains rather than the tougher long-term demands or going for one result and neglecting another important outcome, as when they pursue output increases at the expense of quality. These problems can be difficult to spot, especially if everyone’s attention is focused on headline figures and not what lies beneath them. As Lawler (1971) warned: ‘It is quite difficult to establish criteria that are both measurable quantitatively and inclusive of all the important job behaviours.’

Criteria for effectiveness

The effectiveness of financial rewards in the shape of contingent pay depends on the following factors:

- There must be accurate, consistent and fair assessment of performance or contribution.
- Pay differences can be related to performance or contribution differences and can be seen to be related.
- The principles of procedural and distributive justice are upheld.
- There is a climate of trust in the organization – as Thompson (1992b) commented: ‘Where there is trust, involvement and a commitment to fairness, the (PRP) schemes work.’
- Performance management systems function well.
- Line managers have the necessary skills and commitment.

- Stakeholders, including line managers, employees and employee representatives, have been involved in the design of the scheme.
- The scheme is appropriate to the context and culture of the organization.
- The scheme is not unduly complex.
- The purpose, methodology and effect of the scheme have been communicated and understood
- There is a clear line of sight between effort and reward.
- Rewards are attainable and worth attaining.

Factors affecting the success of contingent pay

- Staff involvement in design
- Amount of consultation • Supervisory skills
- Fit to context and culture
- Staff involvement in design
- Favourable attitude of employees
- Participative management style • Productivity rather than profit orientation
- Communication and understanding of schemes
- Clarification of team goals
- Team independence
- Senior management commitment
- Employee involvement • Employee support
- Emphasis on communications
- Related HR activities, eg training

The dos and donts of financial incentives

Do tie financial incentives to valued behaviours.

- Do have good measurement systems.
- Do have good communications.
- Do make the system complete, ie cover all relevant and valued aspects of performance.
- Do use financial incentives to supplement other rewards.
- Do make meaningful differentiations.
- Do set realistic goals.
- Do provide relevant skills and resources.
- Do emphasize long-term as well as short-term success.
- Do accept reality – use incentives that do work rather than those that should work.

Don't give in to hope and fad.

- Don't equate rewards and punishments.
- Don't rely on invalid behaviour measurement tools.
- Don't keep things secret.
- Don't violate employee expectations

Six tips for using financial rewards

- Provide for the accurate, consistent and fair assessment of performance or contribution.
- Fit the scheme to the context and culture of the organization.
- Keep it simple.
- Involve stakeholders, including line managers, employees and employee representatives, in the design of the scheme.
- Communicate the purpose, methodology and effect of the scheme.
- Ensure that there is a clear line of sight between effort and reward and that the rewards provided by the scheme are attainable and worth attaining.

The theoretical framework

The theoretical framework is based on the concepts of extrinsic and intrinsic motivation. Extrinsic motivation arises when something is done to or for people to motivate them. Extrinsic rewards include pay, praise and promotion. Intrinsic motivation as originally defined by Deci (1975) is provided by the self-generated factors that influence people to behave in a particular way or to move in a particular direction. Intrinsic rewards include responsibility (feeling that the work is important and having control over one's resources), freedom to act, scope to use and develop skills and abilities, interesting and challenging work and opportunities for advancement and growth. In the phrase coined by Herzberg (1968), intrinsic rewards arise from the work itself. It is generally accepted that while extrinsic rewards can have an immediate and, in the right circumstances, a powerful effect on motivation and performance, intrinsic rewards can have a deeper and longer-lasting effect.

Maslow's hierarchy of human needs

Maslow's theory is based on the proposition that human needs are arranged in a hierarchy of significance. At the bottom of the hierarchy are physiological and safety needs that are best satisfied by money. Once these basic needs are satisfied individuals progress to 'higher' needs not associated with money – social needs, esteem and, ultimately, self-fulfilment, which is achieved by being engaged in meaningful work. The problem with this theory is that it was based on interviews with highly creative individuals and has not been verified by empirical research. Herzberg's motivation-hygiene theory Herzberg's theory concentrates on identifying the factors that contribute to satisfaction or dissatisfaction at work. He explained that: 'The factors involved

in producing job satisfaction (and motivation) are separate and distinct from the factors that lead to job dissatisfaction.’ He called the latter ‘hygiene factors’, using hygiene in the medical sense as being preventative, because they can cause dissatisfaction and need to be stopped from doing so. But they cannot produce lasting satisfaction, which means that while financial incentives may motivate in the short term the effect quickly wears off. In contrast the ‘satisfiers’ associated with the work itself (achievement, responsibility, recognition and advancement) have a deeper and longer-lasting effect on motivation. Herzberg’s two-factor theory has been criticized by Opsahl and Dunnette (1966) who stated that the data on feelings about pay ‘seem inconsistent with the interpretations and lend no substantial support to hypotheses of a so-called differential role for money in leading to job satisfaction or job dissatisfaction’. They contended that Herzberg’s research methodology was flawed because no attempt was made to measure the relationship between satisfaction and performance and they suggested that the two-factor nature of the theory is an inevitable result of the questioning method used by the interviewers. Gerhart and Rynes (2003) noted from Herzberg’s (1968) summary of his research that pay was mentioned as a satisfier nearly as often as it was listed as a dissatisfier. It has also been suggested (Schwab and Cummings, 1970; Kanfer, 1990) that wide and unwarranted inferences have been drawn from small and specialized samples and that there is no evidence to indicate that ‘satisfiers’ act as motivators – it has been argued by both Maslow (1954) and Adams (1965) that a satisfied need is no longer a motivator

Cognitive evaluation theory

Deci (1975) defined intrinsically motivated behaviours as ‘those in which there is no apparent reward except with the activity itself’. Deci and Ryan (1985) explained that: ‘Intrinsic motivation is non-drive-based motivation. It is based on the needs to be competent and self-determining (that is, to have a choice). It means that a person carries out an activity in the absence of a reward contingency or control.’ They analysed evidence from over 100 studies (possibly those referred to by Alfie Kohn and Jeffrey Pfeffer), which they claimed showed that when subjects received monetary rewards their intrinsic motivation for rewarded activity declined because it reduced their self-determination through the shift from internal to external control. This led to the development of their cognitive evaluation theory (CET).

They pointed out that ‘Rewards, like feedback, when used to convey to people a sense of appreciation for work well done, will tend to be experienced informationally and will maintain or enhance intrinsic motivation. But when they are used to motivate people, they will be experienced controllingly and will undermine intrinsic motivation.’

Deci et al (1999) followed up this research by carrying out a meta-analysis of 128 experiments on rewards and intrinsic motivation to establish the extent to which intrinsic motivation was undermined by rewards. Meta-analysis is a technique for combining the results of a large number of conceptually related studies to reach generalizations based on statistical criteria. What is called a ‘between-groups design’ is used, in which a rewarded group is compared to a control group (a non-rewarded group) on a common dependent measure (intrinsic motivation). The aim is to establish the relation between the independent and dependent variables of rewards and intrinsic motivation and to determine what factors moderate the size of the relation (eg type of reward and

the basis upon which the reward is given). Relevant studies are identified and the results of each study are transformed into a measure called an effect size, which indicates the extent to which the experimental rewarded group and the control nonrewarded group differ in terms of intrinsic motivation (interest in the task and continuing to carry it out after the rewards have been removed).

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