Incentives: roles, risks and requirements

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- Strong Research Area funded by the Swedish Research Council
- 2.5 MEUR (total), 5 years (2014-2018)
- National research platform: 10 (+1) researchers, 5 universities, both infrastructure and building
- Construction Management, Public Administration, Sociology of Law
- Themes: general procurement issues, collaborative contracting models, sustainability/horizontal policies, innovation procurement, innovation in procurement, organization of procurement functions
Some incentives in construction

- Target cost contracts, often combined with open books
- Fixed fee for risk, profit and overheads, all direct costs cost-reimbursable
- Bonuses for time/schedule, health/safety, retention of personnel, specific goals
- Penalties, liquidated damages
- Bonuses based on qualitative performance criteria (soft aspects)
- Lane rental
- Additional work, shadow of the future
Incentives

Oxford English Dictionary:

— Main definition: an incentive is “something that arouses feeling, or incites to action; an exciting cause or motive; an incitement, provocation, ‘spur’”.

— Other meanings: “pertaining to a system of payments, concessions, etc., to encourage harder work or a particular choice of work”.

Motivation

Two types:

- **Intrinsic** – satisfaction of performing the task in itself because it is interesting, fun, leads to self-development and mastery.
- **Extrinsic** – rewards and penalties

Two perspectives:

- Transaction Cost Economics, Principal Agent Theory
- Psychology/behavioural economics
Important requirements - economic perspective

• Clear relationship between performance and rewards: random aspects and factors outside the agent’s control should not affect outcome

• Rewards are connected to the most important goals (agents may neglect non rewarded aspect)

• Agents are possible to influence – competing reward systems should be considered
Psychology: complex relationship between incentives, motivation and performance

Sanctions change perception of exchange

Figure 1.—Average number of late-coming parents, per week

Extrinsic incentives may crowd out intrinsic motivation if they communicate:

- that the agent’s own motivation to try their best is not respected (or expected)
- loss of autonomy/control (for the Agent)
- that the task is not interesting/meaningful/fun and not worth doing without an extrinsic incentive

Effects depend on perceived intentions

Incentives may **crowd in/**
reinforce intrinsic motivation if they:

- signal that the Agent’s competence and own motivation to try their best is respected, that the task is important and that the Principal is committed
- conform to rules of procedural fairness (jointly agreed, objectively assessed, transparent, flexible, feedback is learning-oriented).
More implications and aspects

- Motivation is different for dull and interesting tasks
- Extrinsic incentives are essential if there is no intrinsic motivation.
- Lay theories of motivation: tendency to over-emphasize influence of self-interest on (others’) behavior – risk that incentives are seen as quick fix


Loss aversion

- Losses loom larger than foregone gains
- People take more risks to avoid a loss than to achieve a gain
- Framing effects – what is coded as a loss?
- Pains/penalties are powerful but risky

Kahneman and Tversky, Prospect Theory
For public servants and professional service providers with complex and meaningful tasks:

• Input control – ensure that new employees/participants have intrinsic motivation

• Incentives tied to overall performance (not closely specified targets) – to avoid sub-optimization

• Non-financial: medals, orders, awards

Empirical studies - general

• Incentives often used also when conditions are not optimal from a strict economic point of view (too much or too little uncertainty, sub-optimal performance targets, difficult to separate performance of different actors)

• Payment not related to performance (US studies)

• Those affected do not understand how the incentives operate

• Strong but differing opinions about incentives
Empirical studies – collaborative contracts

• Common features in target cost contracts:
  – Used to signal collaboration and innovation, to make project more attractive
  – Consultants and subcontractors are excluded
  – Discussions and unclear rules for adjusting target costs – very different approaches
  – 50/50 sharing used intuitively and too often
  – Important how and when the target cost is set
  – Transparency, communication and removal of the fixed price incentive experienced as most important

• Similar performance from incentivised and non-incentivised actors
• Swedish bulients abandon target cost with gainshare/painshare and go for cost-reimbursable with fixed part
Three roles

• Create **extrinsic motivation**

• **Symbolic**: signal collaboration, trust, innovation, efficiency, or control and distrust, legitimize collaboration

• **Process-generating**: new communication, transparency, or negotiations about target cost adjustments

• All roles should be considered and managed, can not be used only as symbols and seldom as extrinsic incentives