New business theory shows compensation plans can make or break a firm

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(PhysOrg.com) -- Greed has been blamed for most of Wall Street's woes and the banking sector's recent collapse, but two professors at Washington University in St. Louis say envy is really to blame. And, they warn, envy is driving top talent from the financial sector and could wreak even more havoc on the economy in the months to come.

Olin Business School professors Jackson Nickerson and Todd Zenger argue in a recent research paper that organizations are destined to fail if pay incentives such as bonuses, retention fees and performance-based salaries are not properly managed. "Our argument is the fact that people envy you or make 'social comparisons' creates costs in organizations. A manager has a variety of ways to address those costs…one of which is we're going to go full steam ahead and create these incentives and live with the social comparisons, negative responses and demands for equal incentives. That is ultimately dysfunctional. Managers need to optimize these costs and their consequences."

Keeping envy in check is a delicate balancing act. Incentives and competition are necessary motivators in corporate culture, but too much or not enough can be deadly. Nickerson and Zenger cite the example of Harvard's Management Co. which came under fire for paying its top executives multi-million dollar fees for managing the university's $27 billion endowment portfolio. When Harvard's then-president, Larry Summers, currently President Obama's top economic advisor, was pressured to restrict compensation, key fund managers quit.

According to Nickerson's and Zenger's theory, government-imposed caps on executive pay will have the same effect at banks. Capping the CEO's pay triggers a cascading effect of limits on all salaries, eliminating incentives and prompting employees envious of un-regulated pay to leave.

"You're going to find people fleeing banks and joining small firms or starting their own firms," says Jackson Nickerson. While the talent exodus from established banks will spawn new ventures and competitors, Nickerson says private and public managers need to acknowledge and deal with the role envy plays in every firm. "Understanding this basic business principle is important for government regulators and legislators who are structuring compensation for the banking industry or the auto industry or any other industry the government is getting its tentacles into. And our theory can help predict what's going to happen."

Provided by Washington University in St. Louis (news : web)