Research briefing

The University of Nottingham

THE NOTTINGHAM SCHOOL OF ECONOMICS

Bankers, beware: the truth about bonuses

Inducing Good Behaviour: Bonuses Versus Fines in Inspection Games

By Daniele Nosenzo, Theo Offerman, Martin Sefton and Ailko van der Veen

Bankers may well love them by the billion, but new research has claimed bonuses don't actually make us work any harder.

According to a study by economists, fines are more effective than payouts when it comes to getting the most out of employees.

The finding emerged amid the continuing furore over the huge bonuses being paid to bankers in spite of global financial meltdown.

Downing Street recently won only modest concessions in its bid to stop banks giving an estimated £7bn in extra payments to staff this year.

The enormous figure has provoked widespread outrage at a time when the country is in the grip of cuts and austerity measures.

Now research by the Nottingham School of Economics suggests bonuses don't even improve a worker's productivity.

Key findings

- Bonuses do not encourage employees to work harder.
- Fines are a more effective method of getting the most out of a workforce.
- The joint earnings of employers and workers are considerably higher – 19% in experiments – when fines are handed out than when bonuses are paid.
- Although employers are better off when fines are introduced, workers earn less than in a scenario without fines.
- It is fines, not bonuses, that enhance efficiency.

Research basis

Experts in behavioural economics carried out a series of experiments to examine the effect of bonuses and fines on performance.

The idea was to mirror not just a workplace scenario but other real-life situations such as tax inspections and even speed-limit compliance.

The study, involving more than 100 volunteers, was carried out by CeDEx, the School's Centre for Decision Research and Experimental Economics.

Subjects were assigned the roles of employers or workers and randomly paired over a number of rounds of an "inspection game".

In each round a worker had to decide whether to supply "high" or "low" effort, while at the same time the employer chose whether to "inspect" the worker or not.

In some treatments the worker received a bonus for supplying high effort when inspected, while in others he was fined for low effort.

At the end of the experiments volunteers were paid a modest cash reward reflecting their performances and the bonuses and fines incurred.

Comments and implications

Study co-author Dr Daniele Nosenzo said: "There are many situations where authorities have preferences over individuals' choices.

"Regulators want factories to observe rules, police want motorists to observe speed-limits, and employers want employees to work hard.

"Exactly how authorities induce compliance when individuals have incentives to deviate from the desired behaviour is a fundamental problem.

"To study this we set up a novel experiment – the first of its kind, as far as we're aware – to compare positive and negative influences."

The results, said Dr Nosenzo, show paying bonuses doesn't encourage extra effort.

He explained: "Employers tended to reduce the frequency of their inspections when they knew they would have to pay a bonus for high effort.

"This has a negative impact on encouraging working, which offsets any positive effect of bonuses. In fact, our subjects shirked slightly more often when bonuses were present.

"On the other hand, introducing harsher fines encouraged working. Shirking almost halved relative to a scenario without bonuses or fines. So it's fines, not bonuses, that enhance efficiency."

In fact, the joint earnings of employers and workers were almost 19% higher when fines were handed out than when bonuses were paid.

However, while employers were better off when fines were introduced, workers earned less than in the scenario without fines.

Prime Minister David Cameron recently threatened to introduce tough legislation to rein in bankers' multi-million-pound payouts.

But the coalition government eventually backed away from wider moves towards imposing a windfall tax or curbs on pay.

Ministers instead opted for a compromise that will publicise details of bonuses and set banks lending targets to kick-start the economy.

Yet critics have dismissed the concessions secured under the Project Merlin agreement as "pitiful", a "pantomime" and a "damp squib".

At present the deal requires only that banks provide the details of their five best-paid employees below board level, though this may be reviewed next year.

Amid continuing public anger, Business Secretary Vince Cable has insisted banks still face "fundamental surgery" in terms of structural reforms.

About the NSE

The Nottingham School of Economics is one of the UK's leading teaching and research departments.

It has a world-class reputation for its research on a broad range of subjects, particularly globalisation, experimental economics and time series econometrics.

Its economists have advised organisations including the Treasury, the Bank of England, the World Bank, the Commonwealth Secretariat, the IMF and the Department for Work and Pensions.

The School's standing among the elite economics departments in the UK was reinforced by the 2008 Research Assessment Exercise, which ranked its "research power" among the top three in the country.

www.nottingham.ac.uk/economics/

Daniele Nosenzo

Dr Daniele Nosenzo joined the Nottingham School of Economics in 2006. Part of his current research is focused on how "social comparison" information (i.e. information about how similar others are treated or behave) affects the behaviour of individuals and organisations.

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