INCENTIVE COMPENSATION SYSTEMS IN SMALL BUSINESSES

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ABSTRACT

Incentive compensation literature suggests that appropriate incentives provide motivation for employees to increase their effort, consequently improving both their performance and organisational performance (Drake et al 1999; Bonner and Sprinkle 2002; Knox et al 2004). However, there is limited research on the use of incentives in small businesses, for which incentives may have unique implications. Of the 104 respondents to a survey of 300 New Zealand small businesses, 46% either use incentives or are in the process of developing an incentive scheme. Furthermore, different business sizes and industry types have different rates of adoption and use different types of incentives. There are many conflicting opinions regarding incentives, and evidence that many small business managers are misinformed about the potential uses and benefits of incentives. However, the overarching theme amongst both users and nonusers is the importance of intrinsic motivators such as task attractiveness, flexibility and employee relationships.
INTRODUCTION

It is often suggested that incentives provide motivation for individuals to alter their effort, and this change in effort can affect the performance of rewarded tasks (Gaetani et al 1985; Banker et al 1996; Drake et al 1999; Bonner and Sprinkle 2002; Chu et al 2006). It is also argued that incentives can be used to align the interests of the individual and the organisation, thus improving employee satisfaction and retention, and organisational performance and competitiveness (Amba-Rao and Pendse 1985; Drake et al 1999; Bonner and Sprinkle 2002; Knox et al 2004). Despite these claims, organisations cannot expect every incentive system to improve the performance of rewarded tasks. Contingency theory suggests that both individual and organisational performance are affected by the fit between the incentive system, the individual and the organisational environment (Dastmalchian and Mansfield 1980; Banker et al 1996; Drake et al 1999; Bonner and Sprinkle 2002; Chu et al 2006).

There is a large body of research on the use of incentives and their effect on performance. However, this research is typically restricted to large businesses (100 or more employees), and it is arguable whether findings from large firms are applicable to small firms (Swanson 1984; Ciccotello and Grant 1995; Chandler and McEvoy 2000; Watson and Wilson 2005).

The 1980s saw the greatest body of research on incentives in small businesses, and little research has been published since. Existing research on incentives in small businesses presents several inconsistent findings and unsubstantiated claims, and leaves many questions unanswered (Cooley 1979; Cooley and Edwards 1985; Dastmalchian and Mansfield 1980; Watson et al 1994; Ciccotello and Grant 1995; Ciancanelli et al 1997; Drake et al 1999; Lee et al 1999; Knox et al 2004).

According to the New Zealand Department of Statistics (2005), 96% of all New Zealand businesses are small – that is, they employ less than 20 full-time equivalent staff. The aim of this paper is to examine the use of incentives in New Zealand small businesses.

The paper is structured as follows: the next section reviews the literature, followed by the survey method used. The results and a discussion conclude the paper.
EXISTING LITERATURE ON INCENTIVES

Theories Regarding the Potential of Incentives

Objectives are fundamental to all organisations. Some of those objectives are complex, such as designing an innovative product or achieving a cost-leader position; others are more elementary, such as making a profit. In order to achieve its objectives, an organisation must motivate its employees towards achieving those objectives. This is referred to as ‘goal congruence’ (Anthony and Govindarajan 2003). It is frequently suggested that incentives provide motivation for individuals to alter their effort, and these changes in effort affect the performance of rewarded tasks (Gaetani et al 1985; Banker et al 1996; Drake et al 1999; Bonner and Sprinkle 2002; Chu et al 2006). Explanations of this phenomenon refer to a number of theories.

Agency theory (Jensen and Meckling 1976) assumes that people are motivated purely by self-interest. Individuals attempt to maximise their own utility, which involves trade-offs between wealth and leisure. Consequently, tangible incentives provide motivation to exert effort in order to increase an individual’s utility.

Expectancy theory (Vroom 1964) is derived from the principle of hedonism, which suggests that people seek to “maximise their pleasure and minimise their pain” (p.9). As a result, motivation is a function of: valence, the value of the perceived outcome to the individual; instrumentality, the belief that if particular actions are taken the outcome will be realised; and expectancy, an individual’s belief that they are capable of executing particular actions. That is, incentives motivate individuals by adding value to the expected outcome, thus increasing effort.

Goal-setting theory (Locke and Latham 1990) suggests that individuals set clear, challenging and achievable goals, which they are motivated to attain. Incentives provide motivation to set goals, motivation to set goals that are more challenging, and motivation to achieve goals.

Social cognitive (self-efficacy) theory (Bandura 1991) suggests that self-efficacy provides the foundation for motivation, goal setting and task selection. Consequently, an individual’s belief about his or her capabilities determines his or her level of effort. If individuals think they can influence the rewarded outcome, incentives will provide additional task interest and motivation. Furthermore, positive outcomes increase self-efficacy, therefore increasing motivation and task interest, and encouraging individuals to set goals that are more challenging.
The human-resource-market model (HRMM) described by Knox et al (2004) holds a different position from the preceding theories on incentives. It proposes that because businesses operate in highly competitive labour markets, incentives are necessary to satisfy and retain valuable staff. The HRMM does not conflict with the other four theories described; it merely introduces external environmental and personal variables that influence the use of incentives.

The preceding theories claim that incentives induce effort. However, whether incentives have a positive impact on performance is dependent on several other factors.

**Dimensions of Effort**

As Bonner and Sprinkle (2002) show, there are various dimensions comprising the “effort construct” (p. 306). Bonner and Sprinkle (2002) believe that effort can be directed either towards current performance or toward learning, to enable improved future performance. Effort directed towards current performance can be categorised by direction, intensity or duration. Effort direction refers to the activity an individual decides to undertake, effort intensity refers to how hard an individual works on an activity and effort duration refers to the amount of time spent on an activity. Ideally, efforts directed toward current performance will lead to immediately improved performance. Incentives can motivate individuals to undertake the rewarded activity, and increase their intensity and duration in order to improve performance. Effort directed towards learning is typified as strategy development (Locke and Latham 1990). Efforts of this nature can lead to deferred improved performance, often at the expense of current performance. Incentives can provide motivation to exert effort directed towards learning. In order to influence an individual’s effort by using incentives, incentive system designers need to understand the dimensions of effort and recognise that incentives can affect each of them. However, it is arguably more important to understand how incentives affect effort.

**The Three Requirements of Incentive Schemes**

For incentive schemes to operate effectively, individuals must be able to influence the performance of the rewarded activity, have the necessary decision-making authority to influence performance, and be well-informed (Schwartz 1978; Ciancanelli et al 1997; Chandler and McEvoy 2000; Bonner and Sprinkle 2002). Without the ability and authority to influence the performance of the rewarded
activity, individuals will lack motivation; consequently, incentives will not result in increased effort. Similarly, if individuals are poorly informed their effort may be in the wrong direction; therefore, incentives will not result in goal congruence or improved performance.

**Factors Influencing the Effect of Incentives on Effort and Performance**

Contingency theory suggests that both individual and organisational performance are affected by the fit between the incentive system, the individual and the organisational environment (Banker et al 1996).

Bonner and Sprinkle (2002) emphasise four variables influencing the impact of incentives on effort and effort on performance, namely: person variables (for example, attitude, internal motivation and skills), task variables (for example, complexity, attractiveness and effort-sensitivity), environmental variables (for example, circumstances, situation, and influences) and incentive scheme variables (for example, performance measures, timing, and selection of incentive system and/or performance measures). Bonner and Sprinkle (2002) describe ways in which these variables determine the effectiveness of incentive systems, thus illustrating the need for alignment between them in order to achieve the desired outcome. For example, if an individual lacks the necessary skills, incentives may increase effort, but effort will not be translated into improved performance. Alternatively, individuals may not exert more effort if they believe they do not have the necessary skills. However, they may exert more effort in terms of learning to obtain the necessary skills.

Dastmalchian and Mansfield (1980) examined the relationship between factors which were most important in determining pay levels and eight ‘organisational climate’ variables. They found skill and effort to be the largest personal determinants of pay levels for manual staff; and union negotiations, market forces and government forces the largest external influences on pay levels. Pay determinants were similar between small and large firms, and bonus schemes for factory staff were common amongst all firms. However, the types of bonuses differed between small and large firms. Dastmalchian and Mansfield (1980) believe that the pay system, the organisational climate, personal characteristics and other external factors affect employee motivation and consequently outcomes.

Researchers have suggested that incentives (external motivators) may erode intrinsic motivation resulting in less effort and poorer performance (Bonner and
Sprinkle 2002; Schwartz 1978). Schwartz (1978) determined what intrinsic and extrinsic factors were considered important motivators, non-motivators, de-motivators and motivational errors. A low salary combined with high commission was found to be the most motivating combination. Bonuses for individual performance, fairness, challenging goals, attractive tasks and contests rewarded with merchandise instead of money were important motivators; and the ability to influence rewarded performance measures was critical. Dislike of the job and better job offers from other companies were the biggest de-motivators. Poor communication, predominantly negative feedback and failure to involve sales staff in decision-making, were the biggest motivational errors. Lastly, fringe benefits were not good motivators as they are often taken for granted.

Drake et al (1999) examined the ways in which accounting cost systems and incentive structure choices interact. Recognising that reducing costs under an activity based costing (ABC) system requires teamwork, they found profits to be highest when ABC is linked with group incentives, because group incentives provide high motivation for cooperation. In contrast, the lowest level of profit occurred when ABC was coupled with individual incentives. These findings contrast with Ciancanelli et al (1997), who found that profit sharing schemes might suffer from free rider problems and resistance from employees due to increased pay risk and profit determination issues.

**Incentives in Small Businesses**

Watson and Wilson (2005) question whether agency and goal congruence issues exist in respect of directors of small closely-held firms. They found that the determinants of compensation for closely-held small and medium-sized enterprise (SME) Chief Executive Officers (CEOs) are firm specific, as opposed to a combination of market considerations and incentive alignment. Conversely, the determinants of compensation for non-closely-held SME CEOs is similar to large companies – that is, a combination of market considerations and incentive alignment.

Ciccotello and Grant (1995) believe that small companies rely heavily on stock options for employee compensation because they require no initial cash outlay, and cash outlay is only required if the company is performing well.

Chandler and McEvoy (2000) and Swanson (1984) both suggest that incentive compensation systems tied to organisational performance may be more effective in
small firms than in large firms, because the effects of an individual’s actions on firm
performance is more directly apparent. Chandler and McEvoy (2000) found that firm
size and outcome-based compensation were positively correlated, and that complaints
about profit sharing due to a perceived lack of influence of employees on financial
outcomes were lower in SMEs. As a result, Chandler and McEvoy (2000) believe that
profit sharing may be more effective in achieving goal congruence in SMEs than in
large companies.

Other literature focuses primarily on senior management incentive
compensation (Cooley 1979; Cooley and Edwards 1985; Carr 1997; Lee et al 1999),
with little attention to other employees in the organisation; the tax implications of
various compensation schemes (Swanson 1984; Ciancanelli et al 1997); and
retirement plans in America (Fishman and Creighton 1998). However, there has been
some research examining motivation in small businesses (Schwartz 1978; Amba-Rao
and Pendse 1985; McEvoy 1984); the implementation of incentive systems in small
businesses (Schuster and DeSalvia 1983; McEvoy 1984; Gaetani et al 1985); and the
number of small businesses using incentive schemes (McEvoy 1984; Amba-Rao and

Findings on compensation of SME CEOs are conflicting. Cooley (1979) found
that managers’ compensation was related equally to sales and profit. Later, Cooley
and Edwards (1985) found positive correlations between CEO compensation and
sales, profitability and CEO equity interests. They also found relationships between
CEO age and compensation. Lee et al (1999) found a significantly positive
relationship between CEO stock ownership and compensation. Furthermore, SMEs
were more likely to emphasise market-based performance (for example, market value
of the firm) than short-term performance (for example, return on equity or assets) in
determining CEO compensation. Conversely, Knox et al (2004) found only a weak
link between compensation and organisation performance. They believed that market
forces determined compensation instead.

Watson et al (1994) found that 62% of SME non-owner managers received
either an annual bonus or a profit sharing payment. They found positive relationships
between compensation and asset size, and asset size and the use of annual bonuses or
profit-sharing schemes, but no significant relationship between firm profitability and
compensation nor between asset growth and compensation.
There is general recognition that hiring and motivating good workers in small businesses is a major problem (McEvoy 1984; Amba-Rao and Pendse 1985). McEvoy (1984) found that only 8% of small businesses base compensation on productivity. The reasons for the lack of performance-based compensation include: difficulties in measuring performance, lack of time, cost and inconvenience. Intrinsic motivators such as task attractiveness and goal setting were seldom used, yet motivators such as these could be provided at a minimal cost. The most common motivational tools were recognition for good work, pay rises and job security. Amba-Rao and Pendse (1985) found 30% of small businesses used incentive payments based on productivity.

Given the lack of recent research on incentives in small businesses and the prevalence of small businesses in New Zealand, this research examines the extent to which incentives are used in New Zealand small businesses, the key reasons for using and not using incentives, the types of incentives used and the effects of using incentives on motivation and performance.

RESEARCH METHODS

Data for this study was collected in August 2006 using a survey questionnaire¹, which was mailed to the human resources manager or equivalent of 300 New Zealand small businesses, randomly selected from the population of small businesses drawn from the Kompass database (www.kompass.com). Small businesses were defined as those that employ a maximum of twenty fulltime-equivalent staff. The questionnaire was accompanied by a cover letter explaining the purpose of the research, the required response date, an assurance of the confidentiality of responses and an explanation of what incentives are: “something that is used to motivate employees to do something”. After one follow-up, 104 usable questionnaires were returned, a response rate of 35%.

Kolmogorov-Smirnov and Shapiro-Wilk tests revealed that the survey data were not normally distributed. Therefore, nonparametric tests were conducted where necessary.

Mann-Whitney tests were conducted to identify any significant differences in the means between early and late respondents, incentive users and non-users, industry types and number of employees. Two statistically significant differences were identified between the two groups. The differences relate to whether or not the

¹ Available from the corresponding author on request.
businesses were using incentives ($U = 807.5, p < 0.01$) and the extent of use of performance-based incentives ($U = 915.5, p < 0.05$), suggesting that late respondents use incentives significantly less than early respondents. Furthermore, significantly inverse relationships were found between response timing and the use of incentives ($\rho = -0.331, p < 0.01$). These results imply that the use of incentives among the population of New Zealand small businesses is not as common as the overall sample results suggest. However, the differences identified will not undermine the validity of the other survey findings because adoption rates should not affect the answers to the other questions.

Wilcoxon Signed Ranks tests were conducted to reveal any significant differences in the means between questions; and Spearman Rho ($\rho$) tests were performed to identify any significant correlations between the questions.

**RESULTS**

**Industry categories**

As shown in Table 1, the respondents represented a range of industries, the most common being manufacturing and service industries.

**Table 1: Industry categories**

<table>
<thead>
<tr>
<th>Industry category</th>
<th>Frequency</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>24</td>
<td>23.1</td>
</tr>
<tr>
<td>Retail, wholesale and distribution</td>
<td>13</td>
<td>12.5</td>
</tr>
<tr>
<td>Construction</td>
<td>12</td>
<td>11.5</td>
</tr>
<tr>
<td>Business services</td>
<td>12</td>
<td>11.5</td>
</tr>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>7</td>
<td>6.7</td>
</tr>
<tr>
<td>Transport and communication</td>
<td>5</td>
<td>4.8</td>
</tr>
<tr>
<td>Other services</td>
<td>16</td>
<td>15.4</td>
</tr>
<tr>
<td>Other</td>
<td>15</td>
<td>14.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>104</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

**The Extent of Use of Incentives**

Forty-six percent of respondents either currently use an incentive scheme (43% of respondents) or are in the process of developing one (3% of respondents). In addition, 24% of the remaining respondents (13% of total respondents) intend to implement an incentive scheme in the future. Where incentives are used, they are usually employed for all employees in the organisation. However, one manager stated, “[Incentives] suit sales staff better than other staff”, and another that “Different
incentives are needed for different attitudes. Some expect bonuses and others work hard for bonuses”.

Fifty-four percent of respondents conduct formal performance reviews on employees and 66.7% of incentive users use performance-based incentives more than occasionally (see Table 2). On a five-point Likert scale ranging from ‘1 = frequently’ to ‘5 = never’, the mean response from incentive users concerning the extent of use of performance-based incentives is 2.36 (standard deviation (s.d.) 1.317, n = 45). Compensation levels are determined in a variety of ways. ‘The going rates’ are used by 40 respondents, 38 use ‘job worth evaluation’ and 50 respondents base compensation on ‘performance’.

### Table 2: Extent of use of performance-based incentives

<table>
<thead>
<tr>
<th>Frequency of use</th>
<th>Number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>17</td>
<td>16.3</td>
</tr>
<tr>
<td>Frequently/occasionally</td>
<td>13</td>
<td>12.5</td>
</tr>
<tr>
<td>Occasionally</td>
<td>*16</td>
<td>15.4</td>
</tr>
<tr>
<td>Occasionally/never</td>
<td>**12</td>
<td>11.5</td>
</tr>
<tr>
<td>Never</td>
<td>46</td>
<td>44.2</td>
</tr>
<tr>
<td>Total</td>
<td>104</td>
<td>100.0</td>
</tr>
</tbody>
</table>

* 15 of these respondents were classified as incentive users and 1 was in the process of developing an incentive scheme.
** 2 of these respondents were classified as in the process of developing an incentive scheme and the remainder were classified as not using incentives.

The Motivations for Using or Not Using Incentives

The most common reasons for using incentives are to improve organisational performance and/or competitiveness (32% of respondents), to induce effort (26%), to retain employees (21%) or to satisfy employees (19%). According to the literature, the primary motivation for using incentives is to achieve goal congruence and to maximise performance (Gaetani et al 1985; Banker et al 1996; Drake et al 1999; Bonner and Sprinkle 2002; Chu et al 2006). Eighty-seven percent of businesses using incentives align their incentives with the organisation’s objectives either directly or indirectly. On a five-point Likert scale from ‘1 = directly aligned’ to ‘5 = not aligned’, the mean score is 2.13 (s.d. 1.10, n = 45), reflecting a close alignment between business objectives and incentives.

The most frequent reason for not using incentives is a lack of need because performance and morale are good and/or incentives are not relevant for the particular business (54% of all respondents). Twenty five percent stated that they do not use
incentives because the business is owner-operated and there are no employees, and twenty percent believed their employees are incentivised by being paid above market rates.

The Types of Incentives Used in Small Businesses

The most common incentives used are bonuses based on individual performance, bonuses based on group performance, commission and the personal use of a company car (see Table 3).

Table 3: Types of incentive used

<table>
<thead>
<tr>
<th>Type of incentive</th>
<th>Frequency</th>
<th>% of users</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonus based on individual performance</td>
<td>28</td>
<td>62</td>
</tr>
<tr>
<td>Bonus based on group performance</td>
<td>22</td>
<td>49</td>
</tr>
<tr>
<td>Commission</td>
<td>15</td>
<td>33</td>
</tr>
<tr>
<td>Personal use of company car</td>
<td>14</td>
<td>31</td>
</tr>
<tr>
<td>Tuition reimbursement</td>
<td>11</td>
<td>24</td>
</tr>
<tr>
<td>Profit/gain sharing</td>
<td>9</td>
<td>20</td>
</tr>
<tr>
<td>Additional paid vacation</td>
<td>8</td>
<td>17</td>
</tr>
<tr>
<td>Insurance</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Performance-based stock options</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Retirement plans</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Other</td>
<td>10</td>
<td>22</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>124</strong></td>
<td></td>
</tr>
</tbody>
</table>

* The total exceeds the number of survey respondents using incentives because some respondents used several types of incentives

The Ways in Which Incentive Systems are Developed and Used

The three prerequisites for an effective incentive compensation system found in the literature are: individuals being able to influence the performance of the rewarded activity, individuals having the necessary decision-making authority to influence performance, and individuals being well informed. Respondents use communication, additional training where necessary, job descriptions and regular feedback to ensure that employees were given adequate authority and information to improve their performance of tasks that carry incentives.

The Effects of Using Incentives

Many respondents commented on the limitations of non-performance-based incentives. They believe that such incentives have a limited effect on employee effort and/or performance, as employees have little control and influence over these incentives. However most feel that staff value non-performance-based incentives
highly and that these incentives have positive effects on employee morale and consequently, employee motivation.

The existing literature on incentives claims that employees are more highly motivated when performance-based incentives and performance measures are self-selected and when employees are involved in setting performance targets (Bonner and Sprinkle 2002). However, only 6% of respondents using incentives allow employees to self-select performance-based compensation and only 17% allow employees to self-select the way in which performance is assessed. Less than half (42%) of businesses using incentives involve their employees in setting performance targets in relation to incentives. Thus, it is surprising to see that over 80% of businesses using incentives perceive incentives to have a positive impact on motivation, employee performance and organisational performance.

Forty-one respondents believe that employees have favourable attitudes towards incentives and a further 13 feel that employees have neutral attitudes. One respondent commented that incentives “help them [employees] to see the bigger picture and understand how they form a part of it”. Others believe the use of incentives enhances teamwork. In contrast, one respondent stated that incentives are “counterproductive”; another that they are a “short-term solution” and three that incentives undermine teamwork by inducing competition. A number of respondents emphasised the need to personalise incentives and to use a variety of both intrinsic and extrinsic motivators. One manager stated, “Employees enjoy the bonuses and trips, but more importantly they enjoy and value the daily work environment and the freedom and flexibility given with their hours”.

There are contrasting opinions regarding changing incentive schemes. Some believe that changing incentives schemes is problematic and not viewed favourably by employees. One manager stated, “The worst thing to do with sales staff is to mess with their commission”. However, another manager felt that “incentive schemes seem to have a useful life and then they must be changed”.

There is only one statistically significant difference in the mean responses between businesses using incentives and those not using incentives, relating to the perceived attitudes of employees towards incentives ($U = 198.5$, $p = 0.025$). This finding implies that businesses not using incentives perceive employees’ attitudes towards incentives to be less favourable than businesses using incentives. However, this finding is limited by the fact that particular managers’ perceptions may differ
from employees’ actual attitudes. Managers may merely be reflecting their own attitudes towards incentives.

**Significant Correlations**

Significantly positive relationships were observed between the frequency of use of performance-based compensation and perceptions of employee motivation ($\rho = 0.421, \ p < 0.01$), employee performance ($\rho = 0.592, \ p < 0.01$), organisational performance ($\rho = 0.424, \ p < 0.01$) and favourable employee attitudes ($\rho = 0.449, \ p < 0.01$). Positive relationships were also found between perceptions of employee motivation and employee performance, organisational performance and employee attitudes towards incentives ($\rho = 0.629, 0.640, 0.697, \ p < 0.01$).

In addition, businesses not intending to implement an incentive scheme are less likely to conduct performance reviews ($\rho = 0.352, \ p < 0.01$) and perceive employees as having less favourable attitudes towards incentives ($\rho = 0.587, \ p < 0.05$). However, as mentioned earlier, these results may be limited by the fact that employees were not questioned directly. Furthermore, those who conduct regular performance reviews are significantly more inclined to use performance-based incentives ($\rho = 0.298, \ p < 0.01$).

There are positive relationships between alignment of incentives with business objectives and perceptions of employee attitudes towards incentives ($\rho = 0.605, \ p < 0.01$), motivation of employees using incentives ($\rho = 0.666, \ p < 0.01$) and performance of employees using incentives ($\rho = 0.515, \ p < 0.01$). However, contrary to expectations, the relationship does not exist with organisational performance. The more frequently performance-based incentives are used, the more likely businesses are to allow employees to self-select performance-based compensation ($\rho = 0.202, \ p < 0.05$), to self-select performance measures ($\rho = 0.200, \ p < 0.05$) and to be involved in setting performance targets ($\rho = 0.305, \ p < 0.05$). Positive relationships were found between the use of commission and perceptions of employee motivation ($\rho = 0.361, \ p < 0.05$) and performance ($\rho = 0.310, \ p < 0.05$) and between the use of ‘profit/gain sharing’ and both organisational performance ($\rho = 0.292, \ p < 0.05$) and favourable employee attitudes towards incentives ($\rho = 0.329, \ p < 0.05$). Where employees self-selected performance-based compensation, incentives have a greater impact on employee performance ($\rho = 0.293, \ p < 0.05$). Finally, where employees have input into setting performance targets, both employee and organisational
performance are more positively influenced by incentives ($\rho = 0.402, p < 0.01$ and $\rho = 0.303, p < 0.05$).

**Significant Differences between Industry Types**

Small retail businesses have a higher use of incentives ($U = 410.0, p < 0.05$) and a more frequent use of performance-based incentives ($U = 420.0, p < 0.10$). Retail businesses have a higher use of commission ($U = 427.5, p < 0.05$) and base total compensation on performance more often than other industries ($U = 234.0, p < 0.10$). The construction industry has a higher use of incentives ($U = 400.0, p < 0.05$) and a greater use of bonuses based on individual performance ($U = 339.0, p < 0.05$). Fifteen of the businesses surveyed are in the ‘other’ industry category, five being not-for-profit organisations. ‘Other’ industries have significantly lower use of incentives ($U = 453.5, p < 0.05$), including performance-based incentives ($U = 376.5, p < 0.05$).

**Significant Differences between Business Sizes**

The effects of the size of the business are shown in Table 4. Businesses with ‘1-5’ employees who do not currently use incentives are less likely to implement incentive schemes in the future than other businesses ($U = 285.0, p < 0.05$). Furthermore, these businesses are less inclined to conduct regular performance reviews ($U = 1012.5, p < 0.05$) and use performance-based incentives (especially bonuses) less than other business sizes ($U = 1023.0, p < 0.05$). Businesses with ‘11-15’ employees who were not currently using incentives were more inclined to implement incentive schemes in the future than other businesses ($U = 152.5, p < 0.05$). In addition, these businesses conducted regular performance reviews more often than other businesses ($U = 512.0, p < 0.05$).

In addition, correlation analysis revealed that there are positive relationships between the number of employees and both the use of incentives ($\rho = 0.225, p < 0.05$) and conducting regular performance reviews ($\rho = 0.266, p < 0.01$).
Table 4: Comparison of mean responses between number of employees groupings (Mann-Whitney U statistics)

<table>
<thead>
<tr>
<th></th>
<th>Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1-5</td>
</tr>
<tr>
<td>Intent to use incentives</td>
<td>285 **</td>
</tr>
<tr>
<td>Formal performance reviews</td>
<td>1013 **</td>
</tr>
<tr>
<td>Extent of use of performance-based incentives</td>
<td>1023 **</td>
</tr>
<tr>
<td>Bonus based on group performance</td>
<td>1126 **</td>
</tr>
<tr>
<td>Bonus based on individual performance</td>
<td>1132 *</td>
</tr>
<tr>
<td>Personal use of company car</td>
<td>1265</td>
</tr>
</tbody>
</table>

**  p < 0.05
*   p < 0.10

DISCUSSION

The most popular types of incentives are bonuses based on individual performance, bonuses based on group performance, commission and personal use of a company car. Retail businesses make significantly greater use of incentives, in particular performance-based incentives such as commission. This finding implies that designing performance measures that individuals are able to influence is easier in the retail industry than other industries. The construction businesses also had a greater use of incentives. The survey reveals significantly positive relationships between business size and both performance reviews and the use of incentives. This supports the work of Schuster and DeSalvia (1983) who found that small firms had more difficulties implementing performance measurement and compensation systems due to a lack of resources.

Fifty-four percent of respondents do not use an incentive system for employees. McEvoy (1984) found that the main reasons for not implementing incentives in small business were difficulty and cost, yet in this study 61% of non-users believe incentives are either unnecessary or irrelevant. Some of these respondents perceive that employees are incentivised through above-market salaries and others prefer to use non-performance-based ‘perks’. There is a sense that small business managers not using incentives are unaware of their potential uses and benefits. One respondent commented, “Incentives are not useful, quality is important not quantity”.

A common theme among both users and nonusers of incentives is that relationships with employees are critical, such relationships providing a great deal of motivation for employees. This finding supports Schuster and DeSalvia (1983), who
found that small business supervisors and their employees had “closer relations”, which was reflected in more favourable attitudes (p. 19). Many respondents thought that incentives were unnecessary due to great team dynamics; some claimed that this was because of family involvement in the business. Furthermore, some incentive users recognised the limitations of their incentives and acknowledged the power of intrinsic motivators such as team spirit, task attractiveness and flexibility. Such findings highlight the complexity of the effort construct (Bonner and Sprinkle 2002) and suggest that intrinsic motivators are more common and powerful in small businesses.

Sixty-seven percent of incentive users use them to improve organisational performance and 54% to induce effort. Both findings are consistent with agency theory, expectancy theory, goal-setting theory and social cognitive theory (Vroom 1964; Jensen and Meckling 1976; Locke and Latham 1990; Bandura 1991; Bonner and Sprinkle 2002; Chu et al 2006). Eighty-three percent of users use incentives to satisfy and/or retain employees, consistent with the human-resource-market model (Knox et al 2004).

Eighty-seven percent of incentive users use incentives to achieve goal congruence and there are significantly positive relationships between business objective alignment and employee attitudes, motivation and performance. However, some nonusers felt that incentives encouraged “dysfunctional behaviour” and resulted in a lack of goal congruence. These findings contrast with Watson and Wilson’s (2005) assertion that agency and goal congruence issues do not exist in small closely held firms. However, the survey results do suggest that goal congruence issues are not as problematic in small businesses due to closer employee relations.

Only half of respondents conduct regular performance reviews and only 28.8% use performance-based incentives regularly. Furthermore, businesses who did not conduct regular performance reviews were significantly less inclined to implement incentive schemes in the future. Conversely, businesses who conducted regular performance reviews were more likely to be using performance-based incentives. These findings are consistent with Amba-Rao and Pendse (1985) who found that small businesses lacked a systematic and rational approach to incentives and that only 30% of small businesses used performance-based incentives.

Gaetani et al (1985) showed that feedback is an effective intrinsic motivator and it is more effective when combined with incentive compensation. The current survey findings suggest that there is a lack of understanding regarding the usefulness of
performance measurement. The findings also suggest that if performance reviews were conducted more regularly in small businesses, there would be a higher rate of adoption of incentives as the difficulties in performance measurement and incentive alignment would be minimised.

Employee self-selection of performance-based compensation and performance measures is very low; so too is employee input into performance targets. Interestingly, respondents felt that the effects of incentives on motivation and performance are still very favourable. This finding provides support for claims that incentives are more effective in small firms due to employee effort being more transparent (Chandler and McEvoy 2000). However, where employees self-select performance-based compensation, incentives have a greater impact on employee performance, and where employees have input into setting performance targets both employee and organisational performance are more positively influenced by incentives. This supports the existing literature that asserts that employees are more highly motivated when performance-based incentives are self-selected and when employees are involved in setting performance targets (Bonner and Sprinkle 2002).

There are significant positive relationships between the use of incentives, perceptions of employee motivation, employee performance, organisational performance and favourable employee attitudes towards incentives. These findings provide explicit evidence of the benefits of using incentives and support existing theories on the positive impact of incentives on effort and performance (Vroom 1964; Jensen and Meckling 1976; Locke and Latham 1990; Bandura 1991; Bonner and Sprinkle 2002; Chu et al 2006). However, a limitation of this study is that it was addressed to and completed by management. Consequently, the study only reveals perceptions of employee motivation and employee attitudes (and employee performance to some extent).

**CONCLUSION**

Existing literature on incentive compensation asserts that incentives have the ability to enhance goal congruence and to improve employee effort, job satisfaction and organisational performance (Gaetani et al 1985; Banker et al 1996; Drake et al 1999; Bonner and Sprinkle 2002; Chu et al 2006). However, the majority of research on incentives examines top management incentive compensation in large companies and neglects to consider the unique environment in which small businesses operate.
As the majority of New Zealand businesses are small, the New Zealand environment has provided a good opportunity for studying incentives in small businesses. As described above, the findings have either supported the existing literature, added to it or contrasted with it.

In conclusion, those businesses not aligning their business objectives with their employees’ objectives, not using incentives and not conducting regular performance reviews may not have attained the optimal fit between the organisation, its owners and its employees. Future research could address employees directly to obtain evidence of employees’ perceptions of the effect of incentives on employee and organisational performance. In addition to measuring the impact of incentives on effort, performance and employee attitudes, future research could measure the effect of different combinations of incentives and different combinations of intrinsic and extrinsic motivators on these factors.

REFERENCES


