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The "Human Side" of Incentives[1]

By Eva M. Meyersson Milgrom

In the wake of the recent subprime crisis, the public is focused like never before on the restructuring of firms in troubled industries: Until securities markets become liquid again, banks and insurance companies not left to die will have to be restructured. Studying the behavior of stakeholders during restructuring is not merely relevant to recent events; it also offers new insights into how workers respond to a combination of financial and status-based incentives. These insights, besides bearing on an array of topics including personnel policy and organization design, can help leaders better manage the restructuring of organizations.

Mergers and acquisitions (M&As) are among the most common ways that firms restructure, allowing them to redeploy corporate assets more efficiently and to discipline management. But the effects of M&As are the subject of long-standing debates. Points of contention include whether M&As create value or simply redistribute firms' wealth among different constituencies (e.g., employees and shareholders). Target shareholders (shareholders in the firm being acquired) generally gain substantially from takeovers, but the evidence on returns to the shareholders of an acquiring firm (known as bidders) is far less conclusive. Whether positive or negative, bidders' returns are small, ranging from +5 to -5 percent.[2] Even though M&As do not always benefit all stakeholders (e.g., acquiring shareholders, managers, and employees), they remain the major tools of restructuring.

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1 This title is inspired by work of Tore Ellingsen and Magnus Johannesson (2008).

2 For U.S. takeovers, average abnormal returns for target shareholders are typically found to be in the range of 15-30% (see Andrade et al. 2001, Brunner 2002).

About The Author

Dr. Eva Meyersson Milgrom is a senior scholar at SIEPR and a visiting associate professor in the Department of Sociology at Stanford University. Her research lies in the interface of economics and sociology with particular focus on socio-behavioral theories and economic growth, with an emphasis on distributive justice, comparative theories applied to organizations and labor markets.

Her recent research is on cohort effects and catch-ups in wages and promotions; status, relative pay and wage growth – the case of mergers and acquisitions. She also works on gender productivity; CEO compensation, and social influence systems and suicides missions. Dr. Meyersson Milgrom teaches courses on *International Comparisons of Corporate Governance Systems, Global Organizations, and Terrorism*. She received her Ph.D. from Stockholm University in 1992.

A takeover typically involves much more than the mere transfer of ownership, and the study of M&As reveals a complex system in which stakeholders' behavior is driven not only by wages and share-values but also by the crucial non-financial incentives and benefits associated with status. An acquired firm may have to undergo major restructuring, often translating to layoffs. Meanwhile, workers in the acquiring firm may be threatened by their new co-workers, raising questions like: Will I be able keep my position in the hierarchical ranking? Will I have access to the new management? Will my new collaborators be of the same quality and productivity as my old ones? Will our firm's and my reputation take a downward turn?

These are classical, if poorly understood, issues in mergers and acquisitions. Many M&As have failed because neglect of status — the "human side" of worker incentives — has caused key personnel to leave, employees to resist changes, and workers to become "demotivated." Some famous cases of strong resistance to M&As are found in the airline business: For example, American Airlines' pilots opposed the company's merger with Reno Airlines because they feared not only that their wages would stagnate but also that they might be replaced by cheaper Reno pilots. Other examples in the research literature include mergers of hospitals (such as the failed and very costly merger between Stanford and UCSF hospitals) and the recent failed merger attempt between Yahoo! and Microsoft. What is the source of this resistance, which is sometimes so strong that it defeats these endeavors to create economic and social value?

The "Human Side" of Incentives

That people evaluate their circumstances and attributes by comparing them with those of others is among the most basic social phenomena. For example, they may compare their wages, authority, or beauty with those of co-workers, neighbors, or friends. Their perceived relative standing in such a comparison is their *status*.

M&As in which the perceived status of workers changes can lead to either frustration or satisfaction, which in turn can affect job performance and turnover. The productivity of satisfied workers may go up, whereas frustrated workers may lose motivation or even attempt to sabotage the restructuring. Status is a crucial aspect of employee incentives, and recent research on status has provided new insights into topics as diverse as personnel policy, organization design, and strategies regarding tax policy, income distribution, and social welfare.

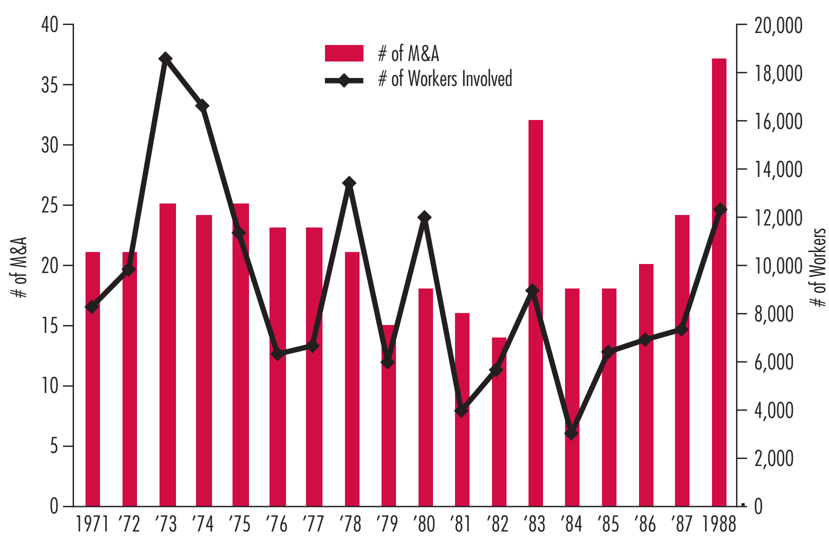
Does Status Really Matter?

Status changes have a tremendous real-world effect on worker behavior. A new study of hundreds of M&As in Sweden (Kwon and Meyersson Milgrom, 2008) highlights new and subtle aspects of this effect.

When employees' relative status sinks after M&As — instead of being at the top of an occupation hierarchy, they might be in the second or third tier — they tend to react by leaving the organization. Sometimes the

FIGURE 1

Number of M&As and Number of Workers Involved



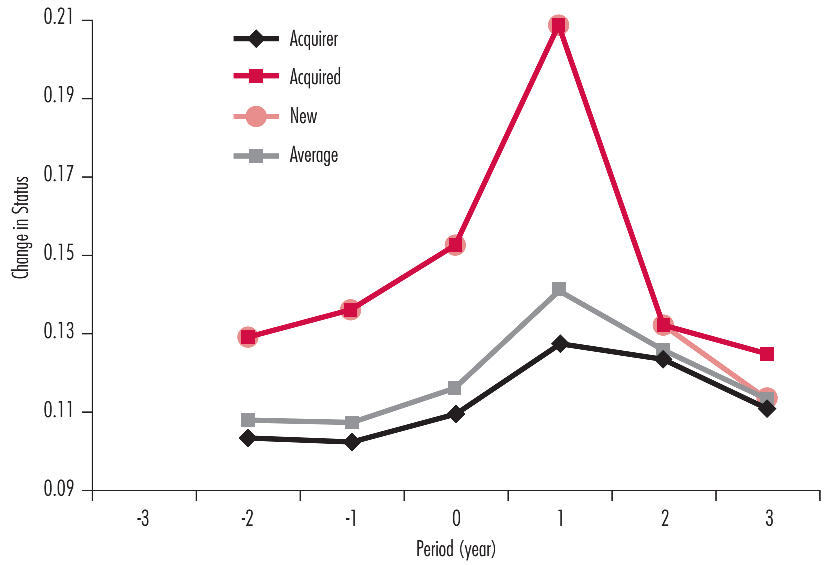
turnover is beneficial to both firms and employees, since it can help create a workforce with a shared vision and promote a better match between the firms' needs and the employees' skills. Sometimes, however, turnover is costly to the organization, as when it precipitates the loss of key personnel or renders employees demotivated, demoralized, and unproductive.

Our research shows that an increase in status with respect to co-workers in the same occupation leads to lower probability of turnover, which suggests a preference for high status. This study found the preference for a one-standard-deviation increase in within-occupation status to be equivalent to that for a 6.8 percent increase in wages. This is a clarion call about the importance of status as an incentive: Status matters to people, and it matters a lot.

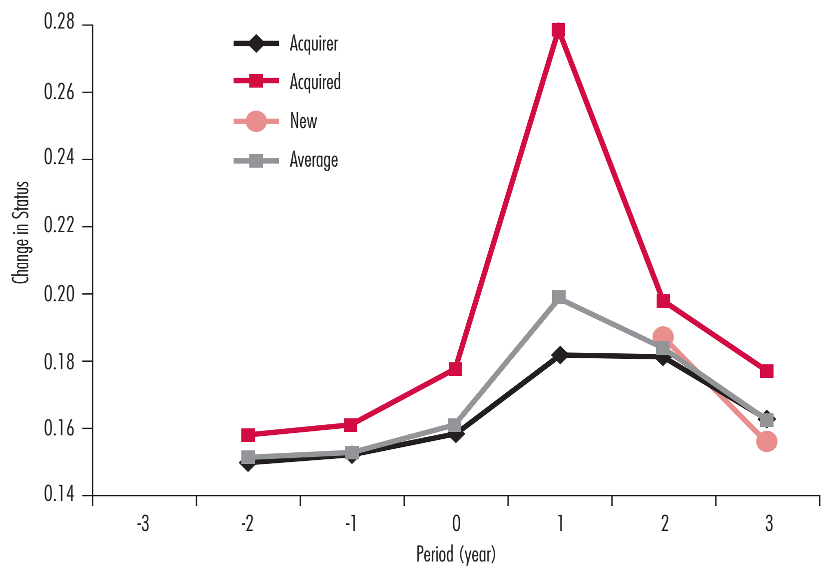
Why *Do* We Care About Status?

Most studies on status have focused on *whether* people care about their status; few have addressed *why* people might care about status. Many simply assume that people care about status for the social benefits it entails: for example, prestige, respect, or perceived fairness. However, even workers' preference for high or low status as shown in Figure 2 does not necessarily imply that these status preferences are driven by social-preference reasons, and sociological and economic theories offer competing explanations.

FIGURE 2 – Changes in Status and M&As



(a) Change in Status within Firm



(b) Change in Status within Occupation

Note: "Change in Status" measures the *absolute* value of actual change in status (from the previous year) within firm or occupation. M&As take place between year 0 and year 1. The dotted lines after year 0 show the statistics of the *remaining* workers from acquiring or acquired firms and of the newly hired workers after M&As. "Average" before year 0 is the average among workers in acquiring and acquired firms. "Average" after year 0 is the average of all the workers in the merged firms.

Sociologists such as Goode (1978), Sorensen (1979), and Jasso (2001) provide various theories of how status can enter into a social preference. In social-status theory, for instance, members of a particular group positively value their own status, which can signify prestige, honor, esteem, or respect.

Economic models, in contrast, have shown how concerns about status can be explained without relying on the concepts of social rewards or social preference. Some scholars assume that the observed preference for status is due to status's instrumental value for future pecuniary benefits such as larger wages or faster promotions. For example, workers may positively value status because it serves as a signal of their unobserved quality, especially when the market only observes the worker's status, not her absolute wage. Podolny (2005) points out that, in this case, higher status can signal higher quality and lead to larger future income. Similarly, in a tournament of promotions such as described in Lazear and Rosen (1981), a worker may positively value status because future payoffs increase with higher status.

Our research, however, finds otherwise. It shows that increases in status (in this study, relative standing in rank or wage) lead not to higher wage-growth rates but rather to lower ones. Still, individuals tend to stay with organizations in which their status does not decrease, despite the lower wage growth. This suggests that high status is not instrumental for future pecuniary rewards; on the contrary, as noted above, workers are willing to give up financial payoffs in exchange for the additional social rewards that result from increased status. Thus financial and status rewards are substitutes as worker compensation.

When Do We Want Higher Status and Why Would We Want Lower Status?

Status implies a comparison of an individual to her group, but people compare themselves with others in various ways, and the reference group for a given status comparison is not always obvious. Most previous empirical studies have either ignored the idea altogether or have chosen reference groups arbitrarily, with almost none allowing for the possibility of multiple reference groups.[3] Kwon and Meyersson Milgrom (2008) is the first to focus on the interaction of two reference groups with which workers may compare themselves. One is the group of those with whom they compete for scarce resources (such as food, mates, or jobs); within-occupation status is such a comparison. The other is the group with which they may compare themselves simply for information-gathering and learning opportunities in a noisy environment; within-firm status is such a comparison.

We find that people's behavior is determined by the reference group they compare themselves with and that people may not always prefer to be at the top of the heap. After M&As, workers tend to leave the firm if their within-occupation status decreases. *But they also tend to leave if their within-firm status* ***increases***. This suggests, perhaps counter-intuitively, that people may have a preference for lower status in certain situations.

Workers prefer lower within-firm status since, holding within-occupation status constant, this implies membership in a superior firm. Conversely, a post-M&A increase in a worker's within-firm status may signal a decline in overall firm quality-less-productive co-workers, less opportunity for learning, decreased labor market opportunities-thus leading to a negative preference for within-firm status after M&As. Workers compare themselves not only to others in the reference group within which they compete for resources; they also compare these groups to other groups in the larger community. Thus an increase in status may motivate a worker to stay at a firm or to leave it, depending on the reference group.

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3 A rare exception is Neumark and Postlewaite (1998), which shows that married women's labor-market participation is influenced by the wage of a sister-in-law: the higher the sister-in-law's wages, the more likely women are to participate in the labor market.

Why *Should* We Care About Status?

Among the simplest, clearest lessons from failed M&As is the difficulty of the social integration of employees in merging companies. Ignoring the importance of status can have serious consequences for the success of M&As. An enriched understanding of worker incentives can promote integration and the creation of social value. Status, in addition to wages, is a major incentive influencing employee behavior in such cases, and employees who lose out on within-occupation status in M&As will resist the restructuring, impeding the realization of the expected value of the merger. But two results of recent research — (1) the substitutability of financial rewards and status rewards as worker compensation and (2) the similar substitutability of increased status and decreased status in differing reference-group comparisons — yield two vital insights into the "human side" of incentives: insights that can contribute to successful integration after M&As.

First, workers' willingness to exchange wages (present and even future) for status is clear evidence that they value status primarily for social-reward reasons, rather than for associated financial rewards. Second, workers' negative preference for within-firm status after M&As indicates that they care about their status, and thus evaluate their own attributes, within more than one distinct reference group and also that the social rewards associated with status vary depending on reference group. Within-occupation status, negative within-firm status, and financial rewards are all substitutable for one another as post-M&A worker compensation.

This insight can help leaders understand, anticipate, and control the effects of status changes on worker behavior in M&As. Our results suggest how firms may avoid losing key personnel during the uncertain period of a merger: Workers that lose out in one dimension must be compensated in another. The good news: There is a market for status, so the loss of status can be compensated either with pecuniary rewards or with an increase or decrease in status relative to a different reference group. An employer who can distinguish more- and less-important reference groups can mitigate worker quits and demotivation. Our burgeoning understanding of the effects of reference groups on status can allow leaders to weigh such considerations when managing mergers and acquisitions, or any situation in which status change is a potentially important worker incentive.

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