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The Strategic Implications of Firm-Specific Incentives

Abstract

This three paper dissertation explores the strategic implications of firm-specific incentives . i.e. incentives that are more valuable to workers in their focal firms than similar incentives elsewhere. The first paper develops the theory of firm-specific incentives. The second paper uses data from 7770 software developers in 94 companies to show that firms with more firm-specific incentives have lower voluntary turnover rates and offer lower wage increases to workers over time – i.e. they exhibit lower wage-tenure slopes. The third paper uses data from 271 software firms to show that small firms have advantages offering incentives that are inherently firm-specific.

The Strategic Implications of Company-Specific Incentives*

EXECUTIVE SUMMARY OF KEY FINDINGS

EMORY

GOIZUETA
BUSINESS
SCHOOL

David G. Kryscynski
Principal Investigator
1300 Clifton Road
Atlanta, GA 30322
David_Kryscynski@bus.emory.edu
www.bus.emory.edu/Kryscynski

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OVERVIEW

This project studied the performance benefits of offering unique perks and/or benefits to software development professionals. For simplicity, any value created for developers is referred to as an "**incentive**" because it may motivate developers to join the company, stay at the company, and/or work harder towards achieving company goals.

The study asked a company expert to rate how difficult it is for developers to find certain incentives at competitor companies and then connected these ratings to performance outcomes. Incentives that are very difficult for developers to find elsewhere are referred to as "**company-specific**." For example, exceptionally positive company reputations, desirable geographic locations, excellent company leadership, meaningful interpersonal work relationships, opportunities to impact company and social outcomes, and so forth, may be very valuable to developers, but very hard for them to find outside of their current companies. These kinds of company-specific incentives may make these developers prefer to join and stay at these companies as well as exert greater effort towards company success.

These incentives have high strategic value for at least two reasons. First, these incentives may be **very costly for competitors to imitate or replicate**, if not impossible. Consider the challenge of overhauling a caustic company culture in order to create an environment of positive and supportive working relationships. Companies that have unusually positive cultures are able to offer a unique kind of value to their developers that competitors cannot easily offer. Second, **these incentives are relatively low cost to maintain**, once in place. For example, the University of Hawaii offers the benefit of living in Hawaii. It is relatively costless for the University to maintain this incentive, but it would be extremely costly for a competitor university to attempt to also offer this incentive. Similarly, a company with excellent leadership will maintain its leadership as part of normal business expenditures, but a company with poor leadership may have to invest tremendous resources into establishing a strong leadership core.

In contrast, incentives such as salaries, cash bonuses, medical benefits, paid time off, and so forth, are very easy for competitors to copy if they are willing to invest resources. For example, offering superior medical benefits is simply a matter of being willing to incur higher costs of premiums for excellent health plans. These kinds of incentives are valuable to developers, but should not provide any sustained advantages in attracting, motivating or retaining talented developers *because* they are so easy to copy. The **best developers can always find better options for these incentives**. They stay for other reasons, despite what they may say when they ask for pay raises or additional bonuses. The empirical findings from this study provide support for these broad statements.

This executive summary provides empirical results from three related research questions:

1. Do companies that offer more company-specific incentives have lower developer voluntary turnover rates?
2. Do companies that offer more company-specific incentives exhibit lower developer salaries?
3. Are small companies better able to offer company-specific incentives to developers?

Approximately 275 technology companies provided usable survey responses for the project. The key findings of the study are as follows:

- Companies that offer more company-specific incentives had lower voluntary developer turnover. Companies in the top 25th percentile in offering these incentives had more than **30% lower voluntary turnover rates** than 50th percentile companies.
- There is no clear evidence that companies that offer more company-specific incentives offer lower base salaries to developers. However, companies that offer more company-specific incentives are able to offer **lower than market level salary increases** to developers without increasing voluntary turnover rates.
- Smaller companies appear to have advantages offering these valuable company-specific incentives. The increased flexibility and more familial relationships in small companies leads to higher company-specific incentives. **Smaller companies may be able to leverage these company-specific incentives** to realize human capital advantages.

The main point for practicing managers is to **focus on creating, offering and/or leveraging company-specific incentives**. These incentives are frequently difficult and/or very costly for competitors to imitate, and many can be maintained at relatively low costs. Thus, specific recommendations rely on an honest assessment of which (if any) incentives are highly company-specific.

For companies that currently offer many company-specific incentives, **managers may consider how to better leverage these incentives**. Potential options may include offering lower than market level salaries and/or offering lower than market level raises over time.

For companies that currently offer no company-specific incentives, managers **may evaluate whether there are some facets of the company that can become company-specific incentives without substantial cash investments**. If there are limited opportunities to create company-specific incentives, managers may consider ways to compensate – attempting to create firm-specific incentives may be very costly. **One option is to evaluate talent aspirations**. Companies without firm-specific incentives may have little hope of consistently attracting, motivating and retaining top talent, but they may be able to attract, motivate and retain mid-tier talent. Shifting recruiting and retention focus on a different talent tier may provide a more realistic strategy for talent attraction, motivation and retention of employees.

INTRODUCTION

Scholars and practitioners have long recognized the importance of human capital for sustained competitive advantages. Human capital frequently underlies the strategic resources and capabilities that allow companies to compete in their product markets. Companies that are better able to attract, motivate and retain the most talented employees should be better positioned to consistently outperform their rivals. Hence, the ever intensifying "war for talent."

Simply attracting, motivating and retaining the most talented employees can only lead to consistent competitive advantages when companies can do so at discounts relative to their competitors. In other words, companies must be able to either retain talented employees at lower costs than rivals, or retain better talent than rivals at the same costs as rivals, or both. Simply retaining similar quality talent at equivalent costs leads to competitive parity, not competitive advantage.

Some companies fundamentally misunderstand this distinction and adopt a "retain-at all-costs" mentality. These companies throw perks, benefits and financial rewards at talented employees to get them to stay and, when they stay, they feel like they have won the battle. From a strategic perspective, these companies may have lost. They may have retained the talented workers, but they may have actually paid premiums to do so. Any potential value they may have gained by keeping these talented employees is dissipated through the higher costs of perks, benefits and financial rewards.

One might argue that the value created for the company can still be greater than the costs of retaining these employees, providing a net benefit for the company. Simply having a net benefit is not sufficient for a competitive advantage, however. As mentioned above, a competitive advantage only exists if this net benefit is larger than the net benefit that rivals derive from their talented employees.

Therefore, the critical strategic human capital question is as follows: how do companies attract, motivate and retain better employees than rivals at similar costs, and/or similar quality employees at lower costs than rivals? In other words, regardless of the talent level of employees, how do companies create larger net benefits from their human capital than their rivals?

The present research focuses on one potential answer to the questions posed above: creating, offering and/or leveraging company-specific incentives. Company specific-incentives refer to perks, benefits and/or rewards that are more valuable to employees in the current company than similar incentives elsewhere. For example, the organizational mission, company reputation, nature of the work, interpersonal work relationships, workplace culture and so forth, may be quite valuable to employees but very difficult to find outside of the current company. Academic research shows that employees are even willing to accept lower salaries in order to work for companies with these kinds of positive attributes.

Company-specific incentives can come in many different varieties. Avon, for example, provides discounts and free products to sales representatives based on their sales performance. These rewards motivate effort and additional sales, but only Avon can cost effectively offer these incentives. These incentives are high-powered and material, but uniquely available at Avon.

Similarly, Pandora radio offered early employees the unique opportunity to break music down to its very basic parts in their efforts to develop a music genome. As a consequence, music enthusiasts were able to engage in job tasks at Pandora that were simply unavailable elsewhere. These rewards were clearly intrinsic and very rewarding for employees, but highly company specific.

There are two main characteristics of company-specific incentives that make them particularly valuable in a company's efforts to realize competitive advantages. First, these incentives tend to be very difficult and/or costly to imitate. In some cases these incentives are impossible to imitate even if a company is willing to invest financial resources to do so. For example, it may be impossible to imitate a company mission or a unique company culture.

Second, these incentives are frequently low cost for the company to maintain once in place. While companies invest tremendous resources in maintaining company reputations, for example, they rarely do so *in order to create value for employees*. These companies invest in reputations to maintain their product market performance, or to increase their ability to gain resources from external stakeholders. The fact that positive reputations also create value for employees is a natural byproduct of company investments in normal business activities. Thus, reputation is relatively costless to maintain *as an incentive*. Likewise, Avon has significant cost advantages in offering free products or cost discounts on Avon products.

In contrast, some incentives are unlikely to be company specific because they are so easy to imitate and implement. For example, offering a high quality healthcare benefit is easy to do if a company is willing to lay out the cash to do so. These kinds of incentives become minimum requirements for companies to be considered in the war for talent, but rarely provide sustained advantages. If these incentives did lead to some advantage, then all firms would quickly implement them, and the advantage would quickly dissipate.

The purpose of this study was to empirically explore company-specific incentives through three related research questions:

1. Do companies that offer more company-specific incentives have lower developer voluntary turnover rates?

2. Do companies that offer more company-specific incentives exhibit lower developer salaries?
3. Are small companies better able to offer company-specific incentives to developers?

The following sections introduce the methodology of the study and then address each of these questions in detail.

RESEARCH METHODOLOGY

The research sample was drawn from a population of approximately 2800 technology companies from three industrial sources: (1) participating companies in the Culpepper and Associates, Inc. yearly compensation surveys for technology jobs, (2) companies listed in the software and related industries in the Hoovers Online industrial list and (3) companies listed in the software and related industries in a marketing contact list purchased from Esalesdata.com.

The study team invited an expert "key informant" at each company to take a survey to measure company-specific incentives. Approximately 800 companies were recruited by phone and internet contacts, and the remaining 2000 companies were only recruited by internet contacts. Participating companies were promised a full report in return for participation. Approximately 350 companies completed surveys resulting in an overall response rate of around 12.5 percent. Of those, 75 were removed from the sample due to incomplete survey responses and missing data. Thus, the total usable sample was 275 companies.

Statistical analyses were performed to check for bias in the participating sample. No bias was detected that would threaten the main conclusions of the study. The 275 usable surveys seem to be a reasonably representative sample of technology companies in the United States.

Company-specific incentives were measured by providing a list of 18-24 incentives that software developers value in their work and asking experts to rate those incentives in various ways. A full list of these incentives is shown in the appendix. The key question was: "how difficult is it for software development professionals to find better options for [INCENTIVE] outside of [COMPANY NAME]?" The higher the difficulty rating, the greater the company-specific incentive score for that item. In addition, experts could write in up to ten additional incentives not listed in the survey and rate those as well.

A company-specific incentives index score was constructed by averaging the difficult score for all incentives that may be difficult to imitate or replicate, even if companies are willing to invest financial resources to do so. A list of which incentives were included is shown in the appendix. Thus, the overall index score represents the extent to which each company offers more incentives that are highly company-specific. In other words, the extent to which each company offers more incentives that competitor companies can’t or won’t imitate.

COMPANY-SPECIFIC INCENTIVES AND VOLUNTARY TURNOVER RATES

Voluntary turnover rates were measured by asking how many developers left voluntarily in the previous year. The number of voluntary leavers was divided by the total number of employed developers at the company to get the turnover rate as a percentage[1].

Statistical models tested the effect of company-specific incentives on voluntary turnover rates, controlling for a number of other variables including industry, company labor productivity, company size, company-specific human capital, material restrictions on employee mobility, legal restrictions on employee mobility, company ownership, percentage ownership held by employees, additional incentives, flexibility of work arrangements, aspects of the human resources function, company life cycle stage, importance of innovation and company age.

The results consistently showed that companies with higher company-specific incentives scores had lower voluntary turnover rates. Figure 1 below shows the predicted voluntary turnover rates based on the company-specific incentives score. As shown in the figure, as the company-specific incentives scores increase the voluntary turnover rates decrease. Companies above the 75th percentile in company-specific incentives tend to have no voluntary turnover.

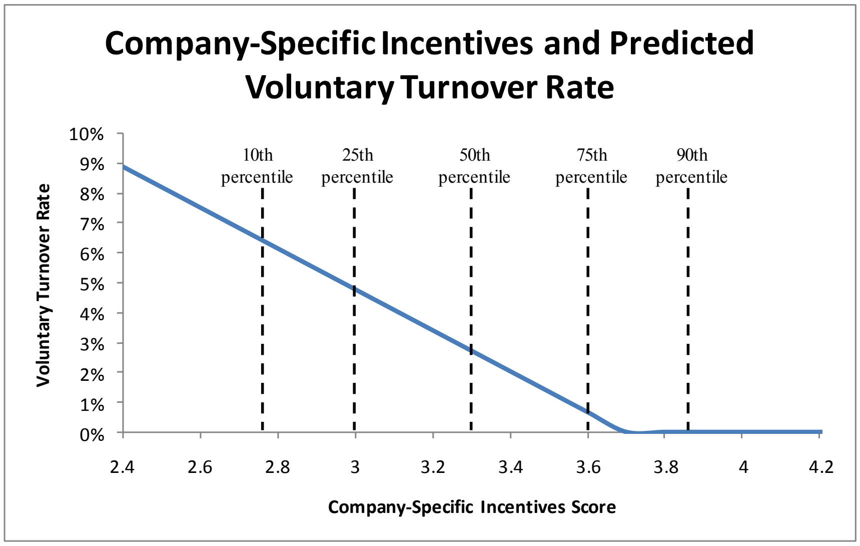

Figure 1: Company-specific incentive scores and predicted voluntary turnover rates

[1] Additionally, companies were asked how many of those voluntary leavers management would have preferred to keep to obtain a measure of dysfunctional turnover, or loss of key employees. These two turnover rates had high correlation in this sample and were not spastically distinguishable from each other. Thus, only the simple voluntary turnover results are reported here.

COMPANY-SPECIFIC INCENTIVES AND DEVELOPER SALARIES

Culpepper and Associates, Inc. provided developer salary data for 7770 software development professionals from 94 of the participating companies.

Statistical models tested the effect of company-specific incentives on base salaries as well as base salary increases over time, controlling for the company level variables mentioned in the prior section as well as individual level variables including job family, industry experience, tenure, eligibility for overtime and eligibility for short term incentives.

The results showed no consistent effect on base salaries. In other words, there is no evidence that companies that offer more firm-specific incentives also offer lower base salaries. However, there is strong evidence that these companies offer lower than market level wage increases as employee tenure increases. This evidence is depicted in figure 2 below, which compares predicted salary over time for companies with high and low levels of company-specific incentives.

Figure 2 shows how predicted salaries change with increases in tenure for developers in a single job family. The important takeaway is that companies with high levels of company specific incentives tend to have very flat salary profiles – i.e. they do not appear to reward additional tenure with higher wages. In contrast, companies with low levels of company-specific incentives tend to have positive salary profiles – i.e. they reward employees for additional years of tenure. Again, these findings control for all other individual level variables that predict salaries.

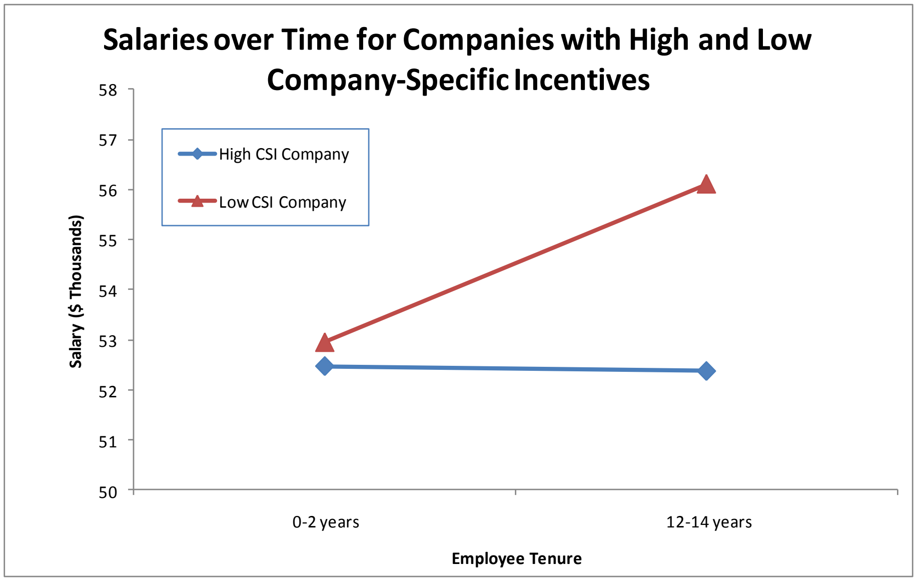

Figure 2: Salaries over time for companies with high and low levels of company-specific incentives

One way to interpret the findings shown in figure 3 is that employees accept lower than market level wage increases over time in companies that have high levels of company-specific incentives. While the present study does not empirically explore why employees are willing to accept these tradeoffs, academic theories suggest that employees come to value to company-specific incentives more over time. For example, the company mission, interpersonal relationships and the nature of the work may become more valuable to employees after they join the company, become socially embedded and buy into the norms and values of the organization.

COMPANY SIZE AND COMPANY-SPECIFIC INCENTIVES

Company-specific incentives lead to lower voluntary turnover rates and lower salary increases, but not all companies are able to create and offer these incentives. Part of what makes these incentives so valuable is that they can be very difficult to create and/or imitate even if some companies are willing and able to invest financial resources to do so. Thus, it is also to explore whether some companies have distinct advantages in creating and offering these incentives.

This section explores whether small companies have distinct advantages in offering company-specific incentives. Conventional wisdom suggests that small companies should have distinct disadvantages in attracting and retaining top talent because they have such limited financial resources. If these companies are better able to create and offer company-specific incentives, however, they may actually have human capital *advantages*.

Statistical models tested whether smaller companies have higher company-specific incentives scores, controlling for the company level variables previously mentioned. Figure 3 (below) shows the results of these models. As company size increases the company-specific incentives score decreases. Overall, it appears that smaller companies offer more incentives that are highly company-specific.

These results do not indicate that all small companies have more company-specific incentives than all large companies. They indicate that, on average, smaller companies offer more company-specific incentives. It seems that small companies may have inherent structural advantages making it easier to create and offer these kinds of incentives to employees. If so, then small companies may be better positioned to leverage these incentives when attracting, motivating and retaining talented employees.

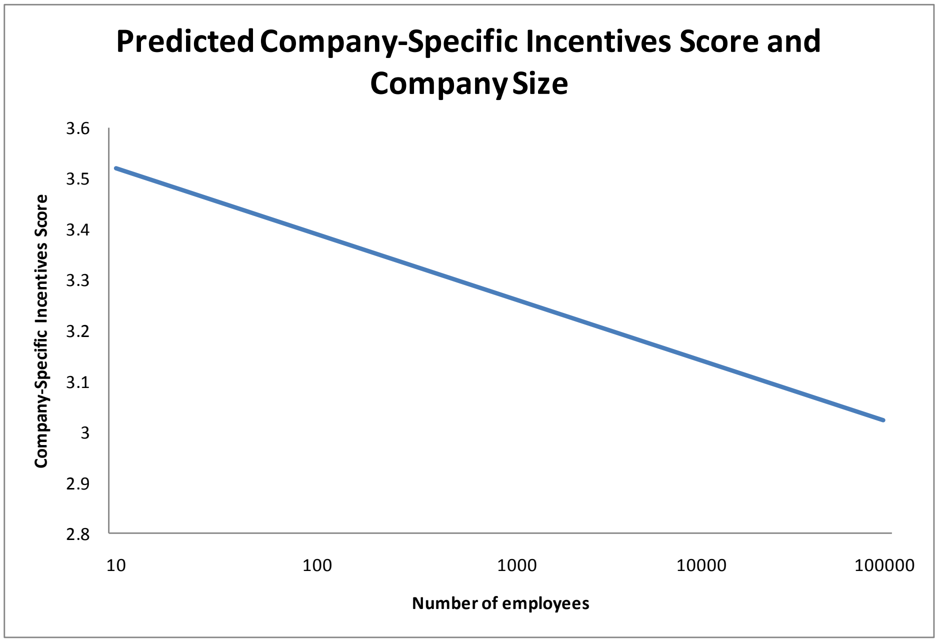

Figure 3: Predicted company-specific incentives and company size

CONCLUSION AND IMPLICATIONS

The results above show that companies that offer more company-specific incentives have lower voluntary turnover rates and offer lower than market level salary increases to employees over time. If these company-specific incentives are difficult for competitors to imitate and relatively low cost for companies to maintain then these findings suggest that company-specific incentives enhance competitive advantage. In other words, these incentives help companies retain talented employees at lower costs than their rivals. Additionally, smaller companies tend to have advantages offering incentives that are highly company-specific.

The practical challenge with these findings is that the very nature of company-specific incentives makes them very difficult to influence. Practicing managers may not be able to easily create and offer such incentives to their employees. Thus, managers may benefit from an honest assessment of which incentives are truly difficult for their talented employees to find elsewhere and which are readily available at competitor companies.

When companies have a set of company-specific incentives already in place, managers may leverage those incentives by adjusting the levels of other costly incentives such as salary or health benefits – i.e. incentives that any company can easily imitate. Doing so may help the company to retain talented workers while simultaneously taking advantage of their willingness to accept salary discounts.

For companies that currently offer no company-specific incentives, managers may evaluate whether there are some facets of the company that can become company-specific incentives without substantial cash investments. If there are limited opportunities to create company-specific incentives, managers may consider ways to compensate – attempting to create firm-specific incentives may be very costly. One option is to evaluate talent aspirations. Companies without firm-specific incentives may have little hope of consistently attracting, motivating and retaining top talent, but they may be able to attract, motivate and retain mid-tier talent. Shifting recruiting and retention focus on a different talent tier may provide a more realistic strategy for talent attraction, motivation and retention of employees.