INCENTIVE SYSTEMS IN AUTOMOBILE DEALERS INDUSTRY – A CONCEPTUAL ANALYSIS WITH REGARD TO CONTRACT THEORY

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ABSTRACT : ***Incentive systems refer to performance linked compensation paid to improve motivation and productivity of employees. They are designed to stimulate human efforts for improvement in the present and for the future goals. Despite of 100 or more years of studies on the impact of incentives, inconsistencies about their value endures. 'Contract theory' by Oliver Hart and Bengtt Holmstrom, which received the Nobel Prize of Economics in 2016 describes about the optimal designs of incentive contracts as an utmost concern by every organization. The automobile industry in India has been on a growth trajectory with remarkable spike in sales, production and exports over the last two years. Rising affluence, easier access to finance and growing affordability is probable to see four-wheelers gaining volumes, although two wheelers will remain the primary choice for the majority of purchasers, lifted by greater appetite from rural areas, the youth market and women. The incentive contract system of the sales personnel in the automobile dealers industry is a major factor which contributes their maximum efforts and performance. The present study is attempted to do a conceptual analysis of incentive contracts in four wheeler Automobile dealers with regard to the contract theory by comparing the three major players - Honda, Renault and Maruti.***

KeyWords: Incentives, Contract Theory, Performance, Automobile Dealers Industry

INTRODUCTION

The success and the persistence of any organization are determined by the system the workers are remunerated and rewarded (Lawler, 2003). The reward scheme and motivating incentives will determine the level of employees' commitment and their attitude to work. According to Dixit and Bhati (2012) poor incentives packages have been a major factor affecting employees' commitment and productivity. For any organization to accomplish its objective in the competitive society, employers of labour must have a broad understanding of what energies the employees need to perform efficiently and reward them accordingly (Mueller, 2011). Besides, employees should be motivated through adequate incentives plans and reward systems and this will invariably encourage them to be proactive and have right attitude to work, thereby to promote organizational productivity (Armstrong, 2007). However, in a highly dynamic organization, incentives and strategies are deployed by employers of labour to ensure that the best brains are retained in the paramount interest of the organization (Nelson, 2003). Accordingly, productivity can only be boosted if the employees are well motivated through adequate incentive packages that are proportionate to their performance (Diener and Biswas,2002, Stolovich et.al, 2002, Michele and Rob, 2008). Meanwhile, to avoid wrong perception and controversy by the employees, reward system must be clearly communicated to employees with job measurement which will drive the much needed motivational drive among the employees(Hartman, 2011). Employee satisfaction and performance are largely influenced by incentive packages or reward system put in place by the organization (Osibanjo et al, 2012). Luthans (1998) divided the incentives used by the organization into two groups as financial incentives and non-financial incentives .

In 2016, economists Oliver Hart and Bengt Holmstrom won the Nobel Memorial Prize in Economic Sciences for their contributions to Contract theory which analyses the optimal design of incentive schemes ("contracts") that induce the involved parties to behave more efficiently. Ackerberg and M. Botticini (2002) in their work on contract choice mentioned a principal with particular characteristics, an agent with particular characteristics, and characteristics of the

task to be contracted on. One then proceeds to solve for the optimal contract form (e.g., the share of output to be given to the agent) as a function of these characteristics. Among other things, the implications of factors such as riskaversion, monitoring ability, moral hazard, and multiple tasks on optimal contracts and the second-best outcome have been examined (e.g., Mirrlees 1975;Grossman and Hart 1983; Holmstrom and Milgrom 1987, 1991, 1994). George P Baker(1992) examines the characteristics of incentive contracts in which the agent's payoff is not based on the principal's objective. The form of the optimal contract and the efficiency of this contract depends on the relationship between performance measure and the principal's objective. CanicePrendergas (1999) address the literature from two perspectives. First, an underlying assumption is that individuals respond to contracts that reward performance. It considered whether agents behave in this way, and whether these responses are always in the firm's interest. Secondly whether firms write contracts with these responses in mind or do contracts look like the predictions of the theory.
In the real world it is often impossible to write complete contingent contracts, e.g. because the actions of some parties are not observable ("moral hazard") or because the actions or the different states of the world cannot be described and verified to a third party such as the courts ("incomplete contracts"). In these situations it is still possible to write contracts, but these contracts cannot enforce the desired behavior directly, they rather have to offer incentives that induce the parties indirectly to behave more efficiently. This could be financial incentives, career concerns, or incentives that are provided by the allocation of control and property rights. The modern contract theory added the ignored two issues of informational problems and incomplete contracts and the optimal design of incentive schemes for managers and workers, the optimal financial structure of a firm, the optimal design of hierarchies and decision structures in organizations, and the optimal allocation of property rights. This theory mentions that the employers must optimally link employee rewards to performance outcomes. The study is attempted to have a conceptual analysis of the incentive systems in Automobile sector with regard to the dimensions of contract .

CURRENT SCENARIO OF INCENTIVE SYSTEM IN AUTOMOBILE SECTOR

India is expected to become a major automobile manufacturing hub and the third largest market for automobiles by 2020, according to a report published by Deloitte. India is currently the seventh-largest automobiles producer in the world with an average annual production of 17.5 million vehicles. With an average production of around 24 million vehicles annually and over 29 million people (direct and indirect employment),the automotive sector in India is one of the largest in the world. India is the largest tractor manufacturer, 2nd largest two wheeler manufacturer , 2nd largest bus manufacturer, 5th largest heavy truck manufacturer, 6th largest car manufacturer and 8th largest commercial vehicle manufacturer. For every vehicle produced, direct and indirect employment opportunities are created with employment of 13 persons for each truck, 6 persons for each car and 4 for each three wheeler and one person for two wheeler. The $93 billion automotive industry contributes 7.1% to India's GDP and 49 % to the nation's total manufacturing GDP(FY 2016-17). As the automotive Industry is a major employment generator, GDP Contributor and FDI earner, the automobile industry is instrumental in shaping the country's economy and hence regarded as the sunrise sector under 'Make in India' campaign. In order to further promote this sector , several initiatives has been undertaken by the Government of India to promote innovation and R & D and create a favorable policy regime to make India a prominent manufacturing destination.
Demographically and economically, India's automotive industry is well-positioned for growth, servicing both domestic demand and, increase in export opportunities. A predicted increase in India's working-age population is likely to help stimulate the burgeoning market for private vehicles. Rising prosperity, easier access to finance and increasing affordability is expected to see four-wheelers gaining volumes, although two wheelers will remain the primary choice for the majority of purchasers, buoyed by greater appetite from rural areas, the youth market and women. The sales force of the dealer showrooms have various level of employees starting from Sales consultant to Zonal Managers.
The dealers have the right to decide on the monetary and non-monetary incentives offered to all their employees augmented by the manufacturer incentives. In the case of Honda dealers they follow a formal contract which fix the monthly targets of each employee to achieve in various brands of Honda. The employees are eligible for the monetary incentives based on their sales volume only if they could achieve more than 80 % of their monthly target which get boosted up by the informal agreements set by the employee and immediate supervisor on a daily or weekly basis. The employees are also eligible for receiving the non-monetary incentives offered by the dealer provided they have won the contests put forward by the dealer. The exclusive dealer for the Renault in Kerala , TVS & sons provide incentives varying for each period and for each model. The incentive system constitute the selling of cars, basic accessories, insurance and financing . The incentives are given only if they achieve 100% target. There are monthly targets for selling cars, accessories and financing. Maruti has around 12 dealers in Kerala varying on their incentives according to the models and seasons . Here the sales executives can sell any of the cars in the showroom for reaching their targets.

CONTRACT THEORY IN RELATION TO INCENTIVE SYSTEMS

Contract theory , won the Nobel prize for its concept in 2016 by Oliver Hart and Holmstrom, covers both behavioral incentives of a principal and an agent which falls under a field known as law and economics, also known as the economic analysis of law. One of the most prominent applications of contract theory is being able to find the optimum design for employee benefits which is a concern in Human Resource Management namely Reward Management.

According to contract theory, contracts exist to put a line between what the principal expects to happen and what will happen. It provides a clear and specific understanding and agreement of how both parties stand and how they should perform. It also covers the implied trust between both parties that all of the constructed representations are valid and will be followed. This problem was raised by the famous "Informativeness Principle" first established by Holmström (1979) and refined and stated more rigorously by Grossman and Hart (1983) which implies that the shape of the optimal incentive scheme in a standard moral hazard problem is incredibly complex and highly sensitive to small changes in the (unobservable) beliefs of the contracting parties about the probabilities of the possible states of the world. The theory yields no robust predictions on the shape of the optimal incentive scheme. This problem is clearly pointed out in a joint survey article that Hart and Holmström (1987) presented at the World Congress of the Econometric Society in 1985. In the 1960s and '70s a literature on moral hazard in insurance and labor markets was developed, dealing with the inefficiencies that arise if the insurance company cannot observe the effort spent by the insuree or if a firm cannot observe the efforts of a worker. Holmström and Milgrom (1987) show that if the agent has a very rich action space, then the optimal contract must be linear in an aggregate measure of the agent's performance. Holmström (1979) proves that the optimal solution must satisfy the "Informativeness Principle" which requires that the wage of the agent should be conditional on all observable signals that contain statistical information about the agent's effort.

APPLICATION OF CONTRACT THEORY IN INCENTIVE SYSTEM OF AUTOMOBILE DEALERS INDUSTRY

Incentives are provided to workers through the compensation practices of firms, including monitoring, evaluation, and contracting, and firms use many different mechanisms to align interests. Sales force employees, are predominantly rewarded for their efforts through explicit contracts that relate pay to observed measures of performance. Others are rewarded not on individual measures of performance but on more aggregate measures, such as profit-sharing arrangements. However, many employers avoid the use of explicit contracts, preferring to reward individuals based on a discretionary subjective measure of performance. Finally, some employers prefer to avoid pay-for-performance altogether. The objective here is to understand these diverse means of compensation and their implications for the provision of incentives for agents to exert effort and allocate their time in the appropriate way.

As per contract theory it is told that the incentives should be linked to performance. By connecting the incentives to observable and verifiable factors the employers can provide incentives. On the other view, the sales person know in prior, that they are getting compensated for the sales volume alone. So they may not give any extra effort to perform in any other aspects like providing proper information about the vehicle, good service for their customers etc. The employees should be compensated by considering the overall performance rather than concentrating on sales volume alone. It is said in contract theory that the compensation of an employee should not be just based on the performance in that organization, they should compare the performance of the same level employees in the other organizations of the same industry. In contrary to that each dealer is deciding what to be given for their employees. With this it can be conceived that the incentive systems should be designed optimally by avoiding the moral hazard problems as mentioned in the contract theory.

CONCLUSION

Incentives prevailing in the Automobile dealer industry fails to have a holistic approach in motivating the employees through the incentive systems by not considering the moral hazard problem and informativeness principle as mentioned in the Contract Theory. Hence it is therefore imperative for the organization to design optimal contracts of incentives by addressing the pressing issues faced by the employees in the automobile dealers industry, to have a better working environment and getting a stable motivated work force in India.

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