THE NEXT DISCIPLINE

APPLYING BEHAVIORAL ECONOMICS TO DRIVE GROWTH AND PROFITABILITY

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"Applied behavioral economics is the mathematical description of the role human nature plays in just about ... everything."
— Jim Clifton, CEO, Gallup

For years, business leaders have struggled to comprehend the apparent irrationality of employee and customer behavior and the impact it has on business performance. To make sense of how employees and customers behave, leaders must first begin to understand human nature and accept that human beings do not always act in rational ways. In today's hyper-competitive global business environment, the secret to driving higher levels of growth and profitability lies in understanding the powerful role human nature plays in the marketplace and in the workplace.

Fortunately, there is an emerging management discipline based on principles of **behavioral economics** that can help business leaders and executives make sense of the economic behavior of real people and serve as a platform for effective management solutions. This is because behavioral economics complements traditional economic theory by filling in the gaps left by the realities of human nature. As a result, it can provide business leaders with insights they otherwise would not have and solutions they never would have considered.

Gallup research revealed that a study group of 10 companies that applied these principles outperformed peers by 85% in sales growth and more than 25% in gross margin during a recent one-year period. The key to achieving this kind of financial performance is for leaders to accept and work with human nature rather than against it. They must abandon outmoded views of human nature by recognizing that people simply are not the rational maximizers of economic gain assumed by classical economic theory.

Instead, employees and customers must be seen as people first and employees and customers second. That means they are subject to all the inherent contradictions, flaws, and emotions that come with being human.

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QUIRKS IN THE SYSTEM

Economics has traveled a long — and not particularly easy — road to arrive at the emerging science of behavioral economics. Early on and throughout much of its history, classical economics has embraced the rational-agent model that characterizes *Homo economicus*, the figurative species of human, as a rational and dispassionate maximizer of economic gain. This view holds that people make economic decisions based on a cool and rational evaluation of all of the available evidence — the benefits of a certain course of action weighed against its costs — before arriving at a decision. The right decision is the one that maximizes an individual's economic gain and minimizes his or her costs.

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But there are quirks in the system that we need to take into account — situations in which real people's behavior does not conform to predictions of classical economics. These "anomalies" make it all the more surprising that the core assumption of the rational-agent model has not changed much in the past 250 years in spite of a mountain of evidence illustrating its flaws. For example, people often use simple, efficient rules of thumb called *heuristics* — what *Financial Times* columnist John Authers calls "mental shortcuts that help [people] survive in the hurly-burly of normal life" — to make decisions such as the tendency to overestimate the likelihood of an event based on how typical the event is. This often occurs in situations where people must estimate probabilities. For example, people will routinely guess that someone who wears tweed jackets and is described as shy and bookish is more likely to be a classics professor than a truck driver, even though there are substantially more truck drivers than classics professors in the world.

Or there is the *simulation heuristic* — the tendency to estimate the likelihood of an event actually occurring based on how easy it is to imagine it happening. For example, you will be much more angry and frustrated if you missed a flight by five minutes than if you missed it by an hour because it is easier to imagine a scenario in which you could have made the flight.

> Our emotional, cognitive, and perceptual processes place limits on how rationally we can view the world around us. ... These limits have a profound effect on the decisions we make — and subsequently on the way organizations need to think about how their employees and customers make decisions and ultimately behave.

Other anomalies in human decision making have been documented, such as the *endowment effect* — first documented by economist Richard Thaler — whereby people place greater value on objects they own compared with objects they do not own. That is, people tend to demand a higher price to part with an object they already own than they would be willing to pay to buy it from someone else. Another is the tendency for human decision makers to be *loss averse*. That is, people feel more pain from losses than pleasure from gains of equal size. For example, individuals tend to be reluctant to accept the prospect of a 50-50 chance of gaining or losing money unless the amount to be gained is at least twice the amount to potentially be lost.

Literally dozens of these heuristics and biases have been documented in the cognitive and social psychological literature and behavioral economics literature — far too many to describe here. But the upshot is that our emotional, cognitive, and perceptual processes place limits on how rationally we can view the world around us and use the information we receive from it. These limits have a profound effect on the decisions we make — and subsequently on the way organizations need to think about how their employees and customers make decisions and ultimately behave.

WHAT IS BEHAVIORAL ECONOMICS?

For the past 30 years, behavioral economics — led by such notable scientists as Daniel Kahneman, Robert Shiller, Richard Thaler, Angus Deaton, George Loewenstein, and many others — has documented many of the flaws in classical economic theory by challenging its foundational premise — that individuals will always behave rationally to achieve the best possible outcome. Instead, behavioral economics emphasizes the role of psychology and the interplay among rational, perceptual, and emotional processes in human decision making and economic behavior. In fact, some have suggested that economic decision making is up to 70% emotional and 30% rational.

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Behavioral economics challenges the central premise of classical economic theory — that individuals will always behave rationally to achieve the best possible outcome.

APPLYING BEHAVIORAL ECONOMICS

At Gallup, our goal is to take the discoveries made within the academic discipline of behavioral economics and apply them to management and business problems. That is, we develop tools and methods to measure and manage both the rational and irrational elements of human nature to drive business success. Thus, for Gallup, ***applied*** **behavioral economics is the mathematical description of the role human nature plays in just about … everything.** This definition spans the full spectrum of issues from how customers and employees create organic growth for organizations to how citizens and institutions build stable and viable societies.

No matter how you define it, it is clear that behavioral economics is now coming of age and exerting an impact in a wide variety of spheres, including public policy and healthcare. For example, a study of radiologists found that attaching a patient's photograph to his or her medical file elicited a more personal, empathetic response from the radiologist, resulting in longer, more thorough reports containing summaries, additional recommendations, and more incidental findings than a typical report. Within the public policy sphere, new applications of behavioral economics principles can be found in the Obama administration's economic plans and senior appointments.

Now that many within academics and government have begun to recognize the need for a more comprehensive (and we would argue, accurate) perspective on human economic behavior, it is time for business leaders — especially those charged with understanding and managing customer and employee experiences — to do the same.

The rise of applied behavioral economics as a management platform is of paramount importance to business leaders because it compels us to rethink the traditional rational/functional models of human decision making that guide many business decisions. Unfortunately, many business leaders (and even many economists) have been slow to embrace these profound changes in perspective, clinging instead to outmoded views of behavior that regard human beings as dispassionate brokers of objective information.

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EVOLVING OUR "INSTITUTIONS OF DATA"

Driving higher levels of growth and profitability in today's business environment requires not only that organizations develop a mastery of applied behavioral economics, but also that they put the right performance metrics in place. Not surprisingly, there has been an evolution in what constitutes the "right" institutions of data to manage our businesses. Until recently, capitalism has been guided by neoclassical economics. This institution of data — stock price, earnings per share, profit, and growth — is what business leaders all trained upon to steer their organizations, divisions, and departments — and to some extent, it served global business leaders quite well. Although these kinds of financial measures continue to be mainstay indicators of organizational performance, developments in the global economy and the financial markets since the beginning of 2008 have underscored the limitations of neoclassical economic theory. It is becoming clear that neoclassical economics — in isolation of developments in other fields such as networks and complex interactions, psychology, and econometrics — may have led us down the wrong path.

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With this in mind, we contend that relying solely on traditional financial metrics as indicators of organizational health is problematic for two reasons. First, neoclassical economics suggests that sales, profit, and the like are leading indicators of how well an organization is doing and will do. However, they are, in fact, trailing indicators — by the time the sale is made and the profit shows up on the income statement, it is far too late to do anything about it. These indicators simply cannot address the issue of what caused a given level of performance in the first place. Second, any incremental benefits of accounting or other financial efficiencies have largely already been realized. Further substantial gains in performance based on attention to neoclassical economic metrics are relatively unlikely, and additional enhancements offer little in the way of competitive advantage for most firms.

The next wave of metrics to emerge were tied to process improvement and quality management — Six Sigma, lean manufacturing, and Total Quality Management, for example. They worked well to improve output quality and wring inefficiencies and costs out of business processes, making organizations more efficient, effective, productive, and profitable. Although mastering this second discipline also continues to be a prerequisite to driving higher levels of financial performance in today's economic environment, the same concerns that apply to using financial metrics as indicators of organizational health also apply to those that focus on process improvement and quality management.

Like financial metrics, much of the benefit of focusing on process and quality metrics now tends to be maxed out and the big gains harder to find. While quality is necessary and declining quality is likely to be a leading indicator of future declines in company performance, improvements in quality are no longer likely to provide a significant competitive advantage for most companies. Likewise, for many organizations, incremental improvements in operational efficiency may continue to provide some cost-reduction benefits, but in our view they, too, will yield little in the way of additional competitive advantage.

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We believe that the next big institution of data will be found in developing new sets of leadership initiatives and metrics around behavioral economics because the gains to be found are much larger than in any other area and because this potential is largely untapped. Mastery of this third discipline — **applied behavioral economics** — holds the promise of realizing breakthrough improvements in employee productivity, customer retention, and real growth and profitability. But precisely how should insights from behavioral economics be applied in business? Metrics based on the application of behavioral economics principles — understanding how to emotionally engage your employees and your customers — provide true leading indicators of future financial performance, indicators that have demonstrated direct and powerful linkages to financial performance outcomes. These leading indicators, in turn, can help managers and executives take corrective action before declines in financial performance occur.

Deploying the right kind of metrics is a necessary first step. The next step is to build a human capital management strategy around the effects of human nature on performance. This is achieved by identifying the innate talents of current and prospective employees and positioning them in the roles that maximize their greatest strengths (the ability to consistently provide near-perfect performance in a specific task). This strategy allows your organization to build a solid emotional infrastructure based on the human nature of your employees to enable consistent and sustained high performance.

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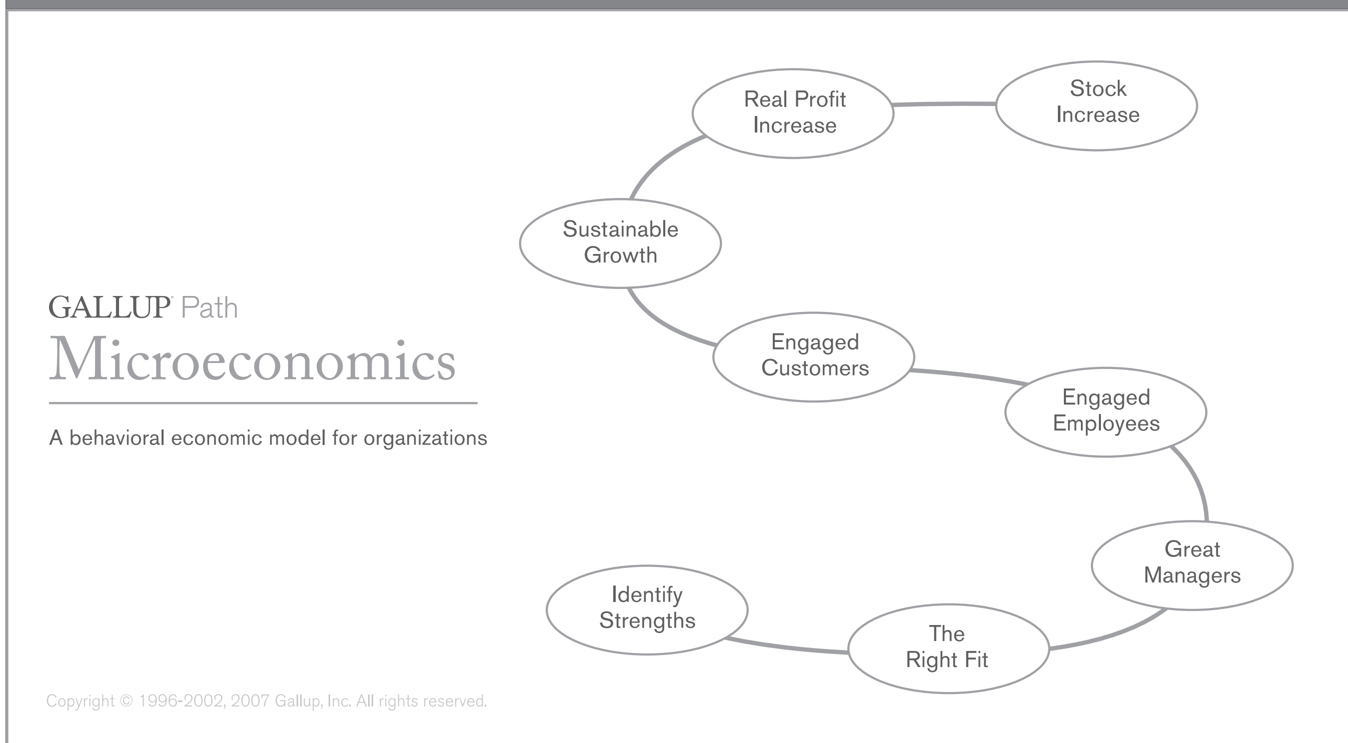
Figure 1: The Gallup Path



APPLIED BEHAVIORAL ECONOMICS AND THE EMOTIONAL ECONOMY

Our work with organizations worldwide has led us to the conclusion that every company has an enormous — but largely untapped — potential for breakthrough improvements in employee productivity, customer retention, and real growth and profitability by understanding and leveraging how human nature drives business performance. This unrealized potential represents an internal economy with its own unique set of rules and dynamics — **an emotional economy** — that can be measured and managed to improve business performance. Most importantly, the emotional economy drives the neoclassical economy.

Before organizations can harness the power of applied behavioral economics, they must build an institutional capability of understanding how the emotional economy works in their organization and in the larger marketplace. Next, they must align their business processes and key performance metrics with this capability to fully leverage the insights afforded by a behavioral economics perspective. Finally, they must deploy these insights effectively to manage and optimize their employee and customer relationships. Gallup has developed a model (see Figure 1) that describes the elements of the emotional economy and how they relate to an organization's wellbeing. The "linked path" relates the individual contribution of every employee to this ultimate goal.

If we were to summarize the key observations from our work with organizations around the world, it would look like this:

1. Customer behavior is influenced more by emotion than reason, and these emotional dimensions can be measured and managed.
2. Employees have a tremendous impact on customers' emotional engagement, for good or ill.

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3. Employee behavior is influenced more by emotion than reason, and these emotional dimensions can be measured and managed.

4. There is vast variation in both employee and customer engagement from location to location and team to team within the same organization.

5. The ability to engage employees depends on identifying the unique strengths they bring to their roles, selecting and positioning them for success by ensuring their strengths fit their roles, and providing them with an engaging workplace and manager.

CUSTOMER BEHAVIOR IS INFLUENCED MORE BY EMOTION THAN REASON

Business leaders, researchers, academics, and management consultants alike have expressed concern that while customer satisfaction may be a necessary foundation for building strong customer relationships, by itself it is a relatively poor predictor of future customer behavior and organizational financial performance. Our data support this concern. Results from a large number of case studies suggest that customers who are extremely satisfied — those who provide the highest rating of overall satisfaction with an organization's products or services — fall into two distinct groups: those who are emotionally satisfied and those who are rationally satisfied. Emotionally satisfied customers have a strong emotional attachment to the organization, while rationally satisfied customers do not. Our research reveals that emotionally satisfied customers deliver significantly enhanced value to an organization, for example, by buying more products, spending more for those products, returning more often, and staying longer with the business. Rationally satisfied customers, on the other hand, behave no differently than customers who are dissatisfied.

This pattern is not limited to customer satisfaction responses; in fact, we see the same pattern for customer advocacy. Findings from a large number of case studies suggest that customers who describe themselves as strong advocates for an organization's products or services — those who provide the highest "likelihood to recommend" ratings — also fall into two distinct groups: those who are emotional (even passionate) advocates and those who are merely rational advocates.

> Emotionally satisfied customers deliver significantly enhanced value to an organization ... by buying more products, spending more for those products, returning more often, and staying longer with the business.

Emotional advocates have a strong emotional attachment to the organization while rational advocates do not. Our research reveals that emotional advocates — like their emotionally satisfied counterparts — deliver significantly enhanced value to an organization, buy significantly more products, spend significantly more for those products, and give a greater share of their total spending to the business. Rational advocates, on the other hand, behave no differently than customers who would not recommend the organization to others.

So if these two traditional standby metrics fail to deliver as advertised, how can we accurately gauge customer sentiment? Taking a cue from behavioral economics, scientists at Gallup developed a method to measure — reliably and accurately — the emotional connections between customers and the organizations that serve them. Our research also sought to demonstrate the linkages between this measure of *customer engagement* and crucial business performance metrics, including customer retention, cross-sell, share of wallet, frequency of purchase, profitability, and relationship growth.

Gallup research reveals that the construct of customer engagement can be defined operationally using three questions that assess the three core aspects of a customer's emotional connection with the companies they do business with. First, does the company always deliver on what it promises? Is this organization trustworthy? Can its employees be trusted do what they say they will do day in and day out? Promise-keeping is the foundation of

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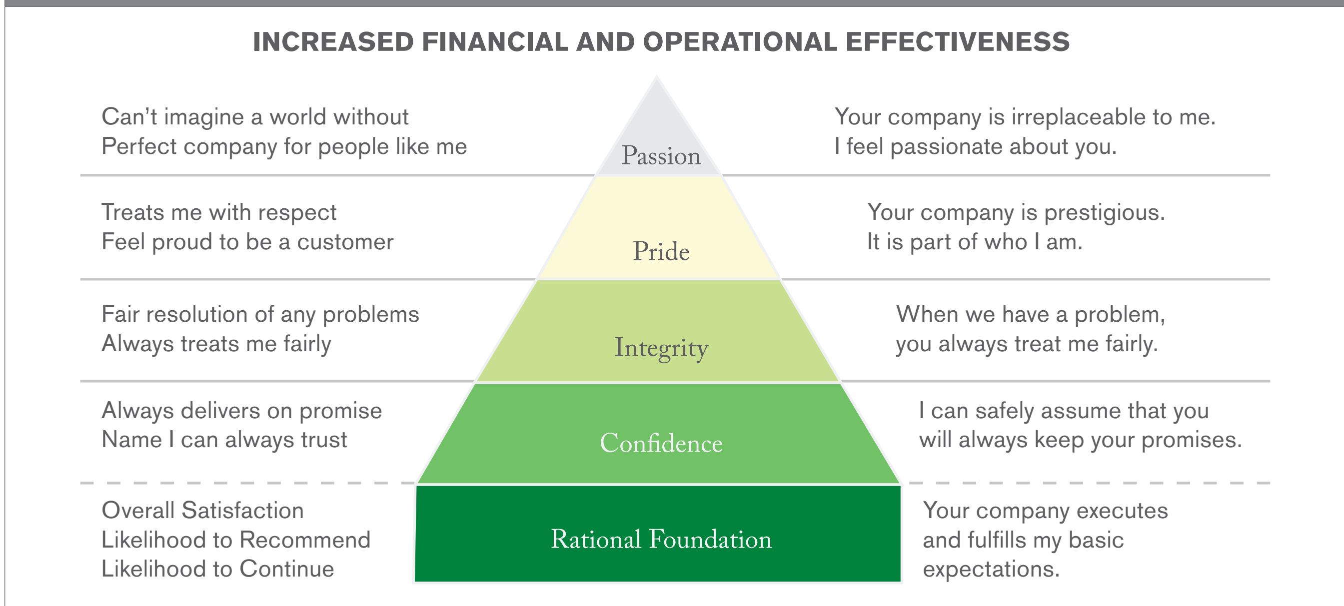
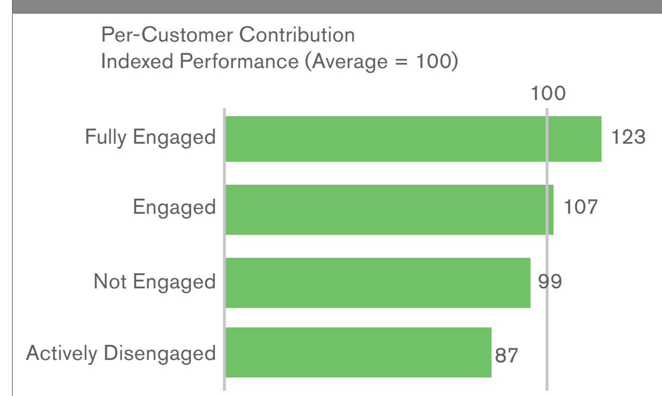


customer engagement. But promise-keeping alone is not enough to build long-term, sustainable, and emotionally connected customer relationships. Next, is the person proud to be a customer? Does he or she have a sense of positive association and identification with the organization? Customers feel pride not because of what their association with an organization says to others, but more importantly, because of what it says to them about themselves. Finally, do customers describe their relationship with the organization as irreplaceable and a perfect fit? If so, they will be customers for life and are worth their weight in gold.

The answers to these three questions determine how engaged a customer is and importantly, serve as a leading indicator of that customer's future behavior (visit frequency, spend, profitability, and retention) toward that company.

As illustrated in Figure 3, our research reveals that across organizations of different types, customers who are fully engaged — those customers who have a strong emotional connection to the organization — represent an average 23% *premium* in terms of share of wallet, profitability, revenue, and relationship growth over the average customer. In stark contrast, actively disengaged customers — those customers whose emotional connection to the organization is weak or absent — represent a 13% *discount*. At a local business unit level (a store, branch, sales team, or other local unit), those whose levels of customer engagement place them in the top 25% of comparable units within an organization tend to outperform all other units on measures of profit contribution, sales, and growth by a factor of two to one. Clearly, engaging customers on an emotional level has a significant financial benefit.



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EMPLOYEES HAVE A TREMENDOUS IMPACT ON CUSTOMERS' EMOTIONAL ENGAGEMENT

On the sales floor, at a hotel front desk, or even in a hospital room, the interaction between an employee and a customer — what we call the employee-customer encounter — is a critical determinant of the financial health of the enterprise. The difference between creating an experience that draws customers back and one that sends them away from your organization forever has large effects on the productivity and profitability of the organization.

EMPLOYEE BEHAVIOR IS INFLUENCED MORE BY EMOTION THAN REASON

Just as engaged customers are among an organization's most profitable patrons and passionate advocates, engaged employees are an organization's most productive and efficient workers. Engaged employees want their organization to succeed because they feel connected emotionally, socially, and even spiritually to its mission, vision, and purpose. They are involved in and enthusiastic about what is happening in their local work environment.

Among the many variables that differentiate engaged and disengaged workplaces is the quality of the local workplace manager and his or her ability to successfully meet a core set of employees' emotional requirements, as shown in Figure 4. These requirements include delivering on the most **basic needs** in the workplace — clear expectations and the materials required to do the job. Once employees are armed with clear expectations and proper equipment, they need to feel that they are making an **individual contribution** to the organization and that those contributions are recognized and valued. Employees perform best in activities they inherently enjoy and for which they have a well-developed predisposition. It's also crucial that employees feel they belong to something bigger than themselves and develop a strong sense of **teamwork**. Finally, employees who have the opportunity to discuss their progress and who have opportunities for personal and professional **growth** build a deeper emotional commitment to the organization. A psychologically committed employee in an engaging work environment is primed for innovation and productivity.

Figure 4: Employee Engagement Hierarchy

Teams of emotionally engaged employees deliver significantly better growth (productivity, profitability, and customer) and cost-reduction (turnover, absenteeism, theft, and safety) outcomes than disengaged work teams. Similarly, organizations that engage their employees grow their earnings more than 2½ times faster than organizations that do not.

In the board room and at the leadership level, principles of behavioral economics play out in a variety of decision-making situations, with substantial implications for organizational performance. From the biasing effects of *sunk costs*, to the tendency to be swayed by how a decision is initially positioned or *framed*, to the tendency to be resistant to changing the *status quo*, executive decision-making processes are extremely vulnerable to the ill effects of cognitive and perceptual biases and heuristics. Fortunately, many of these ill effects can be overcome — or at least reduced — with appropriate training, awareness, and discipline. But before they can be overcome, executives must be made aware of them and the situations in which they are likely to arise.

THERE IS VAST VARIATION WITHIN THE ORGANIZATION

Consider the following: An apparel retailer claims to be an industry leader in customer satisfaction, citing an independent study of customers in the category. A retail bank announces that it has won an award for being one

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of the country's best places to work for the fifth year in a row. While each of these claims may be legitimate, candid conversations with customers who shop in the store's different locations or visit different bank branches will inevitably reveal a large range in the quality of the customer-employee encounter at those organizations. Within the same retailer, one store location may deliver exceptional service while another struggles to drag customers through the door. Within the bank, some branches may be exceptional places to work while others are oppressive. In fact, the variability within an organization easily dwarfs the differences between competitors. Substantial variability in customer and employee engagement represents a significant threat to the sustainability of the enterprise and drags down financial performance.

Local performance variation is a scourge to organizations that aspire to high performance.

The existence of a broad range of performance variability within an organization suggests that the only way to manage that variability and improve local performance is to provide performance feedback at the level where it originates. In practice, this means at the store, bank branch, local office, or sales team — the local level where employees spend most of their time, where customer interactions occur, and where the customer experience is created. Because most managers' spheres of influence are circumscribed and local, the metrics they rely on to manage must also be focused locally. Local measurement and feedback also permit the identification of teams and locations that excel at managing their own local emotional economies. These optimized locations can provide critical guidance to the rest of the organization on how to manage these elements of the emotional economy that are important and difficult to replicate. Nonetheless, local performance variation is a scourge to organizations that aspire to high performance.

IDENTIFYING STRENGTHS, SELECTION, FIT TO ROLE, AND GREAT MANAGERS

From a behavioral economics perspective, high performance organizations recognize the need to understand and accept human nature at the individual level, person by person, and to leverage it to drive performance. Human nature dictates that every individual has a unique set of characteristics, strengths, and weaknesses. These strengths lead to consistent, near-perfect performance in a specific activity, and, importantly, they can be assessed. But because everyone is different, not everyone can be successful in every role. Therefore, it is essential for organizations to optimize each new and existing employee's potential (and their team's likelihood of success) by working with human nature, rather than against it, as much as possible. Knowing your employees' most naturally powerful strengths helps you understand how best to position them for success.

For new employees, this means deploying a disciplined selection process to match prospective employees' strengths to the demands of their roles. This will increase their likelihood of success and their ability to perform at the level of excellence. For existing employees, a manager's goal should be to use each person's unique strengths to maximum effect, rather than trying to change the things that are difficult or even impossible to change. Employees whose supervisor focuses on their strengths during performance reviews are more than 2½ times as likely to be engaged as those whose supervisors focus on their weaknesses. Gallup has researched this topic for more than 35 years, studying more than 6 million people in the process, and we have found that individuals and organizations have much more potential for growth in areas of great strength than in areas of weakness. By individualizing your organization's approach to selecting and managing employees and working with human nature rather than against it, you'll unlock their maximum potential and your maximum profitability.

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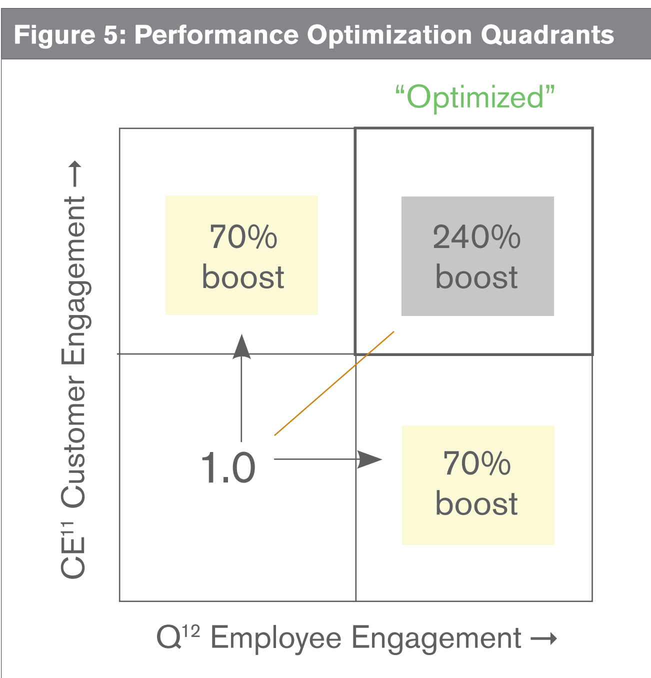
OPTIMIZE: EMPLOYEE AND CUSTOMER ENGAGEMENT INTERACT TO DRIVE PERFORMANCE

Conventional views of the relationships among employee attitudes, customer requirements, and financial performance have emphasized their sequential nature. You can think of these variables as successive links in a chain, in which each variable affects the next to drive some ultimate outcome. This perspective suggests that engaged employees create engaged customers who foster organizational success by delivering positive financial outcomes. Though this perspective has some validity, we believe it fails to convey the true multidimensional nature of the interdependencies among employee and customer engagement and overall organizational financial performance.

Employee engagement does have a direct and measurable relationship to — and impact on — customer engagement. But the ways in which employee and customer engagement interact to enhance an organization's financial vigor are more complex than a simple linear chain of factors. This is because the combined impact of engaging an organization's employees and customers simultaneously is substantially greater than the effects of engaging employees or customers separately. Employee engagement and customer engagement interact to drive even higher levels of financial performance. This *Performance Optimization* model (Figure 5) suggests that gains in team-level financial performance can be driven exponentially by simultaneously optimizing both employee and customer engagement. In fact, "optimized" teams within an organization — those that are in the top 50% of teams on both employee and customer engagement — generate a 240% boost in financial performance compared with teams that fail to engage their employees and their customers. Furthermore, optimized teams also significantly outperform those that scored high on one but not the other of these metrics.

Figure 5: Performance Optimization Quadrants



CONCLUSION

Gallup's applied behavioral economics approach starts by accepting our human nature and capitalizing on it to select and position employees, manage and motivate them, accelerate their development, and unleash innovation and productivity, all to ultimately engage the emotions of your most valuable asset — your customers. Contrary to popular wisdom, our emotional traits are in fact quite predictable, and it is this long-ignored aspect of employee-customer relations that holds the key to superior performance and long-term growth.

CONTACT US

For more information about Gallup or our solutions for optimizing business performance, please visit Gallup.com or contact Stephanie Holgado at 202.715.3101 or stephanie_holgado@gallup.com.

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