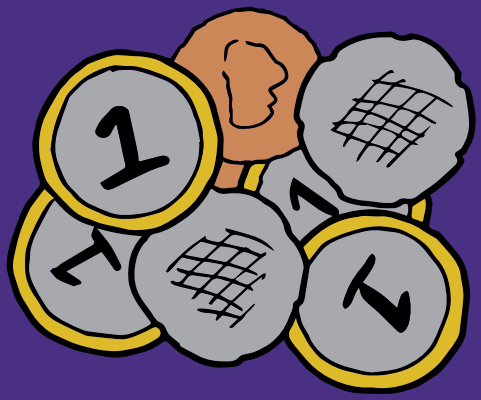
MERIT MONEY



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Money can't buy happiness, but it can make you awfully comfortable while you're being miserable.

Clare Boothe Luce,
American author
(1903–1987)

Paying people for work, without destroying their motivation, is one of the most difficult challenges for management. Regrettably, most compensation systems are considered unfair by employees and unscientific by experts. That's why it would be wise to consider some lesser-known alternatives that are based on real merits instead of imagined performance.

Jojo runs a business. His revenues are good, but the income varies significantly. One month he wonders if he will be able to survive the slowness of summer; another month he wonders if his bank account can survive the next stampede of customers. And yet, Jojo pays himself the same somewhat conservative salary every month. It's enough to pay for his food, mortgage, and novels, but not enough for that vintage Eames lounge chair he has always wanted.

However, today he wants to allow himself something extra. The exports to Norway last month earned him twice the amount he makes in Germany. His Chinese customer ***finally*** paid the invoice he had already written off. And hurray! After two years of ignoring his marketing, the Americans have now discovered his services too. Jojo thinks this all calls for a little celebration, and a pat on the back. After all, ***he*** did all the work, didn't he? He considers a transfer of a little ***extra*** money to his private account, just for once. Maybe he can read his next novel in a new chair.

Why not? He earned it.

Earning Money

What if Jojo is not a one-person company but a bigger organization? Should it be any different? In many organizations, employees get a steady monthly salary which is conservative enough for the organization to survive and enough for people to pay their bills. (See the chapter "Salary Formula")

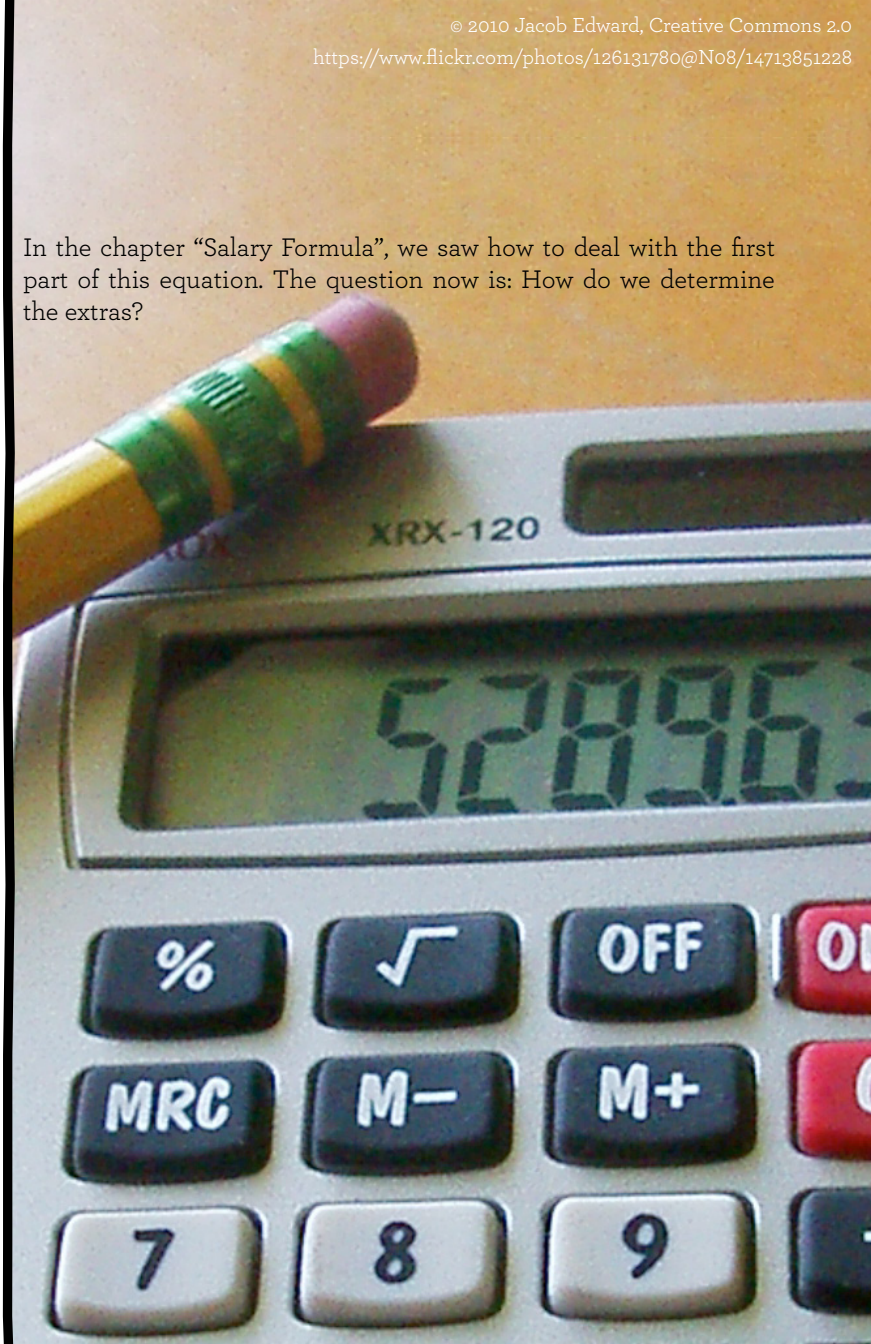
But what if the business climate is favorable and there's some *extra* money available? Increasing everyone's salary is often not an option. You should only do that when you know it is sustainable. Spending the money on improvements in the office is fine, but usually this benefits some workers more than others. And keeping the money in the organization's bank account is virtually the same as giving it to the business owners.

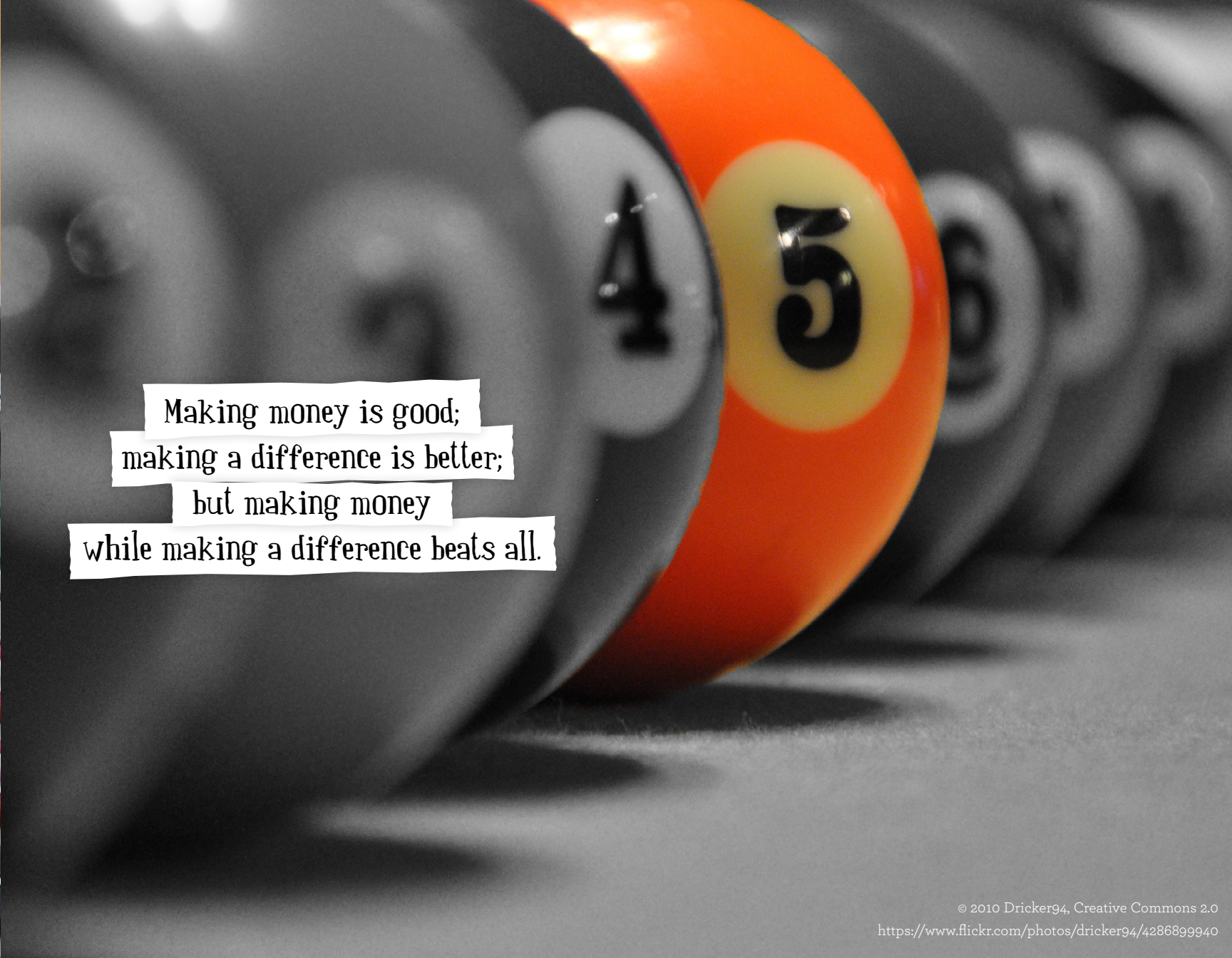
I believe that creative networkers should be given what they *earn*. It is not enough to say that workers aren't primarily motivated by money (which is true) and that they prefer to pursue a greater purpose (which is also true). "Money doesn't motivate people" is not a useful answer to the question "How do we pay employees fairly for their work?" Whatever purpose they pursue, there is probably still money involved in making things happen. Making money is good; making a difference is better; but making money while making a difference beats all.

What people earn is a result of an organization's interaction with its environment. An organization's income cannot be fully predicted; therefore, what people earn should be the sum of their (predictable) salaries and any (unpredictable) extras the organization can afford to hand out.

Earnings = salaries + extras

In the chapter "Salary Formula", we saw how to deal with the first part of this equation. The question now is: How do we determine the extras?





Bonus Systems

> We recruit a person into what we proudly claim to be a knowledge organization boiling over with interesting tasks and challenges. We offer a fair base salary, but then add that "We really do not expect you to do your best. The tasks and the environment we can offer is probably not motivating enough. We will therefore put you on a bonus system. Only then do we expect you to go that extra mile." Unintentionally, this kind of message says quite a lot about the company and our new colleagues.

Bogsnes, Implementing Beyond Budgeting loc:737

A practice that has infiltrated the business world like a pestilence in a shantytown is the **annual bonus system**. (Also see chapter "Kudo Box and Kudo Cards") The idea of this practice is that managers give workers targets, and calculate annual bonuses that usually depend on people's performance ratings, job position, salary, overtime, age, shoe size, and a host of other variables. The common rationale behind the bonus system is to incentivize performance. But actually, it stinks.

Traditional bonus systems rarely have a positive effect on people's performance.

Decades of research has confirmed, again and again, that traditional bonus systems rarely have a positive effect on people's performance when they are involved in creative knowledge work. [Kohn, *Punished By Rewards*; Pink, *Drive*] On the contrary, the effect is just as likely to be negative. [Fleming, "The Bonus Myth"; Spolsky, "Incentive Pay Considered Harmful"] There is so much wrong with traditional incentive programs that it is impossible to list all the problems. But I feel incentivized to give you the most important ones here. [Fleming, "The Bonus Myth"; Kohn, *Punished By Rewards*; Pink, *Drive*]

1. People get addicted to regular rewards, and if they don't get their anticipated reward, they will feel disappointed or punished. This ultimately destroys motivation and thus performance. (See chapter "Kudo Box and Kudo Cards")

2. Individual rewards disrupt collaboration which is crucial in creative knowledge work. Individual rewards stimulate competition and cheating, which destroys the relationships between workers, and also between workers and their managers.

3. Traditional bonus systems rely on objective measures, but reality is far too complex to capture in numbers. The metrics often ignore the soft side of good performance, including teamwork and collaboration. (See chapter "Metrics Ecosystem")

4. Research shows that rewards distract people from complex work, disrupt creative thinking, and increase people's stress levels. This causes them to play safe and prefer easy tasks, while innovation requires the opposite: taking risks and doing complex tasks.

5. The research also shows that bonuses undermine intrinsic motivation and altruism. As soon as rewards are handed out, people start to think, "They pay me extra for this work; thus, it cannot be fun, interesting, or good."

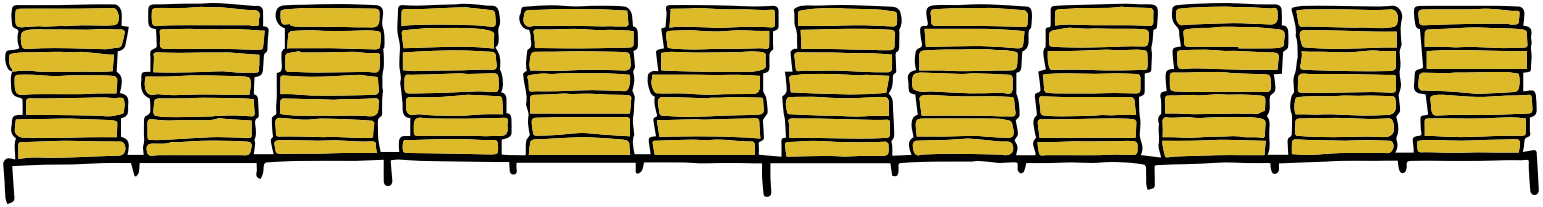
It should also be noted that bonus systems are usually based on company profits. But creative networkers cannot directly relate their work to their company's profits, because most of what influences profits—a combination of systemic effects and environmental factors—is beyond their immediate control. [Bomann, "Bonus Schemes Should Be Handled with Care"]

Flat Systems

Some people argue that organizations should get rid of their bonus systems entirely. They say most of an organization's performance is in the system, not in the people, and therefore, it's best not to differentiate between employees. Everyone should get a steady salary and (maybe) an incidental bonus that is the same for everyone. Some even go as far as to suggest that there shouldn't be any incidental bonuses at all. Only Christmas bonuses seem to be appreciated, but those count as anticipated (and therefore promised) bonuses; they are not intended to redistribute unexpected extra income of the organization. In other words, these people are all in favor of a **flat system**, without any unanticipated extras.

I believe a flat compensation system doesn't address the challenge of paying employees what they really *earned*. First of all, there is the problem that roughly 80% of all people think they perform better than average [Haidt, *The Happiness Hypothesis* pag:67], and thus, when everyone gets paid the same as everyone else, 80% of workers will feel underpaid. (It won't be true, but you can't argue about feelings without real data.) Second, while bad fortune in business is usually absorbed with conservative salaries and incidental layoffs, good fortune should likewise be enjoyed through extra payouts and by hiring new people. When you don't pay any extras to workers, the workers share the burden of setbacks, while only the business owners reap the benefits of success. This is probably not motivating to most people. It has certainly never motivated me.

A flat compensation system doesn't address the challenge of paying employees what they really earned.



Merit Systems

In an organization that is operating in an uncertain environment, I believe workers should have a steady salary that is predictable and slightly conservative. On the other hand, they should also get extras depending on the unpredictable part of the environment. Both salaries and extras should be brutally fair and based on merits, not equality. This has led me to suggest the following practical constraints for better compensation systems based on the five problems listed earlier:

1. **Salaries should be expected, but bonuses should not.**
Always keep bonuses a surprise. When bonuses become frequent and anticipated, they ought to be converted to regular salaries.

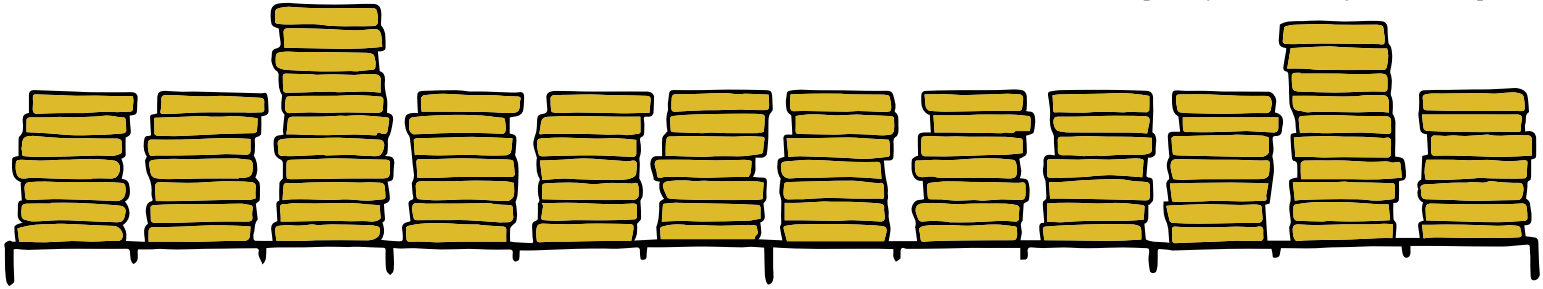
2. **Earnings should be based on collaboration, not competition.**
When determining how much people should earn, the main criteria should be their collaborative work toward a common goal.

3. **Peer feedback is the main performance measurement.**
Contributions to a shared purpose are best detected and evaluated by peers, not by managers. Only the whole system knows all the details.

4. **Use creative thinking to grow the compensation system.**
Expect that people can (and will) game any system, and tap into that creativity by inviting and supporting it, instead of driving it out.

5. **Use compensation to nurture their intrinsic motivation.**
Make money a reflection of people's curiosity, honor, acceptance, mastery, and all other intrinsic motivators.

Of course, implementing these suggestions for a compensation system is not a trivial thing, but I have discovered different ideas that seem to work rather well for various creative organizations. These ideas also turn out to be quite compatible with each other as well as with the science of behavioral economics. [Ariely, *Predictably Irrational*]



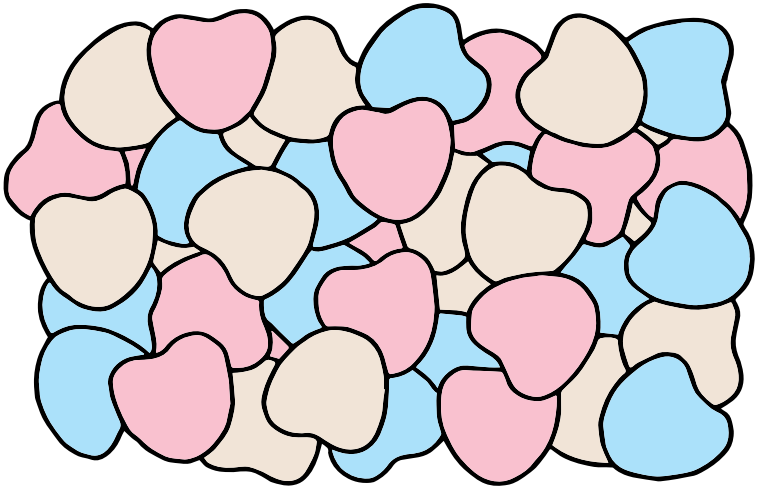
Virtual Currencies

Any manager can start a merits-based earning system in her organization—covering people's extra income, not their regular salaries—and for the remainder of this chapter I will assume you are a manager. (As an individual employee you could do this as well, but when your span of control covers just your own money, it makes little sense to redistribute your bonus to yourself.) The distribution of money is a sensitive topic; therefore, you have to treat this workout practice with proper care.

The first thing you do is set up a ***safe-to-fail environment***. You can consider reserving just 10% of the current annual bonuses for the new system. It is not necessary to ignite a company-wide revolution either by yourself or by disgruntled employees. Take it easy. Start in a way that allows you to fail and learn.

The second thing you do is create a virtual currency to represent the merits that people can accumulate over time. You can use ***credits, points, coins, hugs, beans, candies, bananas,*** or anything else to represent recognition of people's contributions to the network. It is important not to use real money because the monetary value of the virtual currency is ***zero*** until management decides there is a good reason to convert the virtual money into real money. For virtual coins, I will use the term ***hugs*** in this chapter because a hug clearly has no monetary value, and we generally give hugs to others, not to ourselves. (I tend to hug myself when I'm sleeping, not when I'm working.) The exchange rate of a ***hug*** to a euro, dollar, yuan, or other official coinage is 1 to zero.

The third thing you do is decide which organizational units can collectively receive ***hugs*** besides getting them individually. Within a self-organizing team, recognition of merits is a relatively easy thing. People all know each other personally, and they have a good sense about who contributed what to the team's collaborative work. I have a good idea which of my team members helped me get an article published before a deadline. I know who paid for coffee last time. (It certainly wasn't me.) And I know who stole my socks. (Yes, I know where they are!!) On the other hand, I get good service from my accountant, but I don't know if it's really him or the team behind him doing all the work. More generally, when organizational units work with representatives, others in the organization usually cannot distinguish between the work of the representative and the work of the entire unit. As a manager, you should therefore decide whether entire units could also be the beneficiaries of hugs.

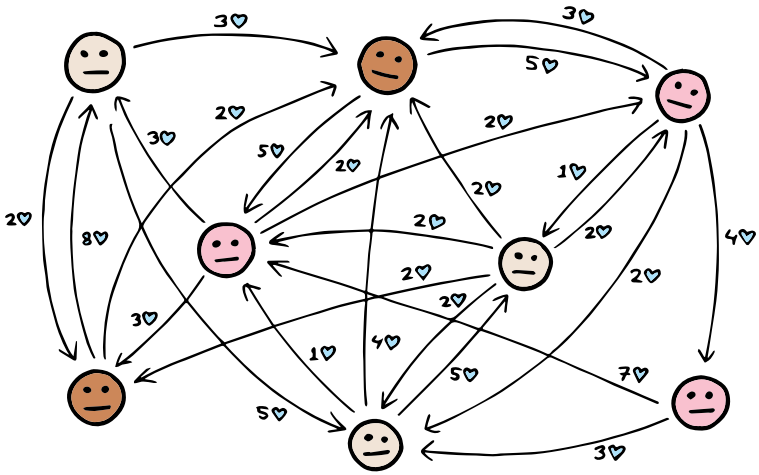


Peer Recognition

Now we get to the core of the merit system. The next step is for you to define the total amount of *hugs* available, and how often they will be passed out. My suggestion would be to do this once per month, but I'm sure other frequencies (weekly or quarterly) are possible too.

And then the fun starts.

The single most crucial aspect of a merit system is that every individual can only recognize the contributions of other people, and that the opinions of all individuals have equal weight. Therefore, everyone in the organization gets an equal share of the *hugs*, but **every employee must give away his *hugs* to others.** [Boyd, "At IGN, Employees Use a 'Viral Pay' System"; Culbert and Silva, "What If Your Peers Decided Your Bonus?"]



> Nobody can claim to have the best definition of what performance is and what collaboration means. We should, therefore, use everyone's opinion equally.

You have just created a market for merits, and, like any other market, you can expect to witness unpredictable and amazing creativity. One worker may decide to share her *hugs* equally among all her team members. Another worker can use a personal metric, such as compliments received or productivity observed, for the distribution of his *hugs* to his peers. Another worker can give half of her *hugs* to one colleague who helped her out when she was feeling depressed and on the verge of quitting her job. Workers are also allowed to give away *hugs* to people or units outside their own team. After all, good working relationships don't limit themselves to formal organizational boundaries.

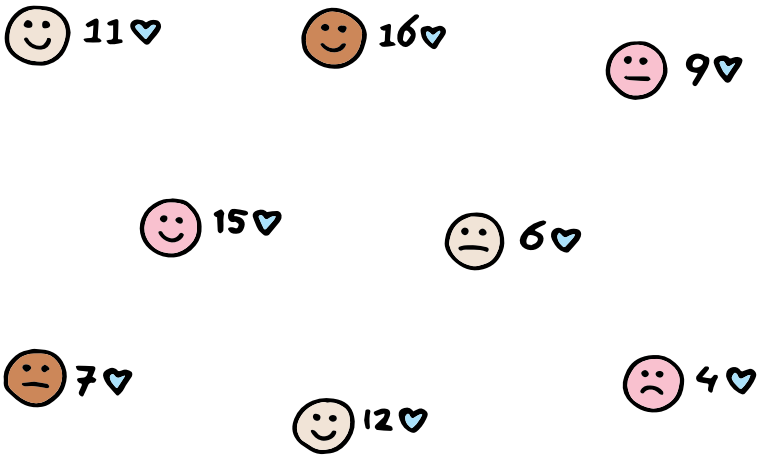
The central idea of the merit system is that nobody can claim to have the best definition of what performance is and what collaboration means. We should, therefore, use *everyone's* opinion equally. This can be viewed as the **wisdom of the crowd**. [Surowiecki, *The Wisdom of Crowds*] Instead of *claiming* rewards, which is usually the case in salary negotiations and annual bonus systems, all merits have to be *earned*. After all, social science says human beings are keen observers of other people's behaviors, but very poor at evaluating their own. [Haidt, *The Happiness Hypothesis* pag:66] Therefore, the *claimed hugs* (everyone claiming an equal share) only become meaningful by converting them to *earned hugs* (through peer feedback and recognition by others).

What happens to people who get less than expected?

It is said that 80% of all people believe they perform better than average. However, depending on the distribution of hugs, roughly 50% of the workers will get more hugs than the average. This means that an estimated 30% of the workers could feel disappointed that their work is not recognized by their colleagues, or at least not as much as they had expected. These people have a choice. They can either learn how to do better, accept the fact that not everyone can win gold in the Olympics, or else find another place where they believe their contributions will be better appreciated.

The criteria for passing out *hugs* should be related to a shared purpose as well as values and principles that inspire people. For example, the question that people could ask themselves is:

What did others do that helped us to engage people, improve work, and delight clients? Did someone get us a step closer to achieving our purpose?



Given the fact that a healthy organization will have a mixture of individual goals, team goals, and organizational goals, it will be up to the individuals to find a healthy balance between the needs of employees and units. No written policy or procedure can calibrate intrinsic desires in an organizational network. That task is better left to the most complex device in the known universe: the human brain. All available brains, in fact.

Working more than 100%

Many companies use financial bonuses to "make people perform" and to get "more than 100%" from their employees. The result is often that employees' personal time suffers from putting in extra work hours so that they don't lose out in the bonus rat race. Some say a merit money system will not work in such an environment. Indeed, I agree.

Your company might need more than just a switch to another rewards system. For example, you will need an inspiring purpose and a healthy organizational culture (see chapters "Work Expo" and "Value Stories and Culture Books"). You will probably need to get rid of traditional performance evaluations and individually negotiated salaries (see chapters "Feedback Wrap" and "Salary Formula"). And people might need better performance transparency and more control over their own work definitions (see chapters "Metrics Ecosystem" and "Work Profiles and Project Credits").

The suggestion that people feel pressured to work "more than 100%" is a clear sign of a traditional business culture. There is no such thing as 100% in a community of happy workers. People should work as much as makes sense to them and earns them respect among peers, given an inspiring purpose, healthy values, transparent metrics, and a steady income. Creating this environment is a responsibility of management.

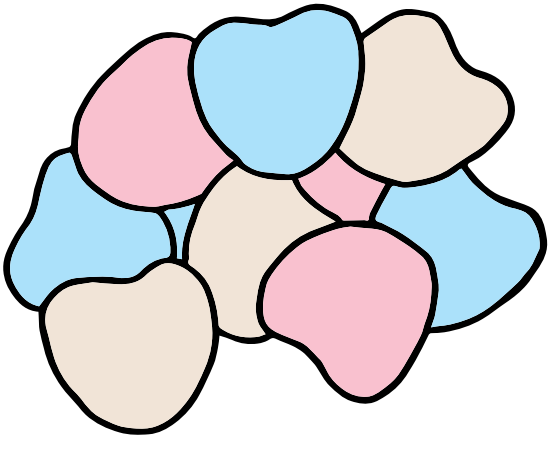
Cashing Earnings

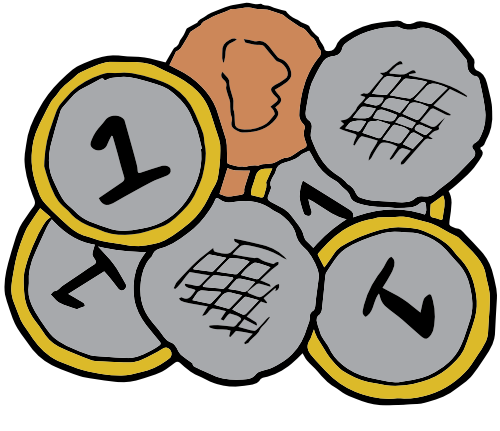
After a number of iterations and people's ***earned hugs*** have accumulated over time, there will (hopefully) come a time for ***hugs*** to be cashed in, using a certain exchange rate. / There are different ways for doing this.

Every month, management could set aside a bonus, with a total value depending on business profits. They could then ask the newest employee (or someone else who has the least to gain from a possible payout) to roll two dice. Management will only allow ***hugs*** to be cashed when the number rolled is four (or some other favorite number). If any other number comes up, the bonus will simply roll over to the next month. This means the bonus money becomes available only once per year on average, accumulating each month, but paid out at random intervals. This would make people feel less stressed about anticipated bonuses. Less stress is important for creative thinking.

The financial value of ***hugs*** can be published like shares on a stock market. It will depend on the bonus money available and the number of outstanding ***hugs***. When the ***hugs*** become cashable, people could have a choice. Either they convert their ***hugs*** to real money now, or they save their ***hugs*** for the next round, in the hope that the value will go up. (An additional idea is to have an expiration date on earned ***hugs***, similar to frequent flyer miles with airlines. Another idea is to limit the total number of hugs people can save; similar to upper limits for unused vacation days.)

Several alternative programs can be conceived, depending on the culture of the organization, the kind of business it is in, and the bonus money available. But whatever specific implementation an organization comes up with, merit systems in general are much more likely to help people focus on shared purpose and collaboration than traditional programs with numerical targets and annual bonuses.



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Six Rules for Rewards

The merits-based system as described here satisfies the five constraints I listed earlier. The system keeps any big rewards unexpected; it emphasizes collaboration instead of competition; it relies on peer feedback; it invites rather than destroys creative thinking; and it aligns rewards with various intrinsic motivators such as honor, acceptance, mastery, freedom, relatedness and goal (see chapter "Champfrogs Checklist").

Depending on how you implement a merit system, you could also satisfy the six rules for rewards that were outlined in the chapter "Kudo Box and Kudo Cards":

1. **Don't promise rewards in advance.** People know what salary they get every month, but (in the ideal version of this practice) they don't know if and when there will be something extra. Bonuses should depend on the environment, not on a calendar.

2. **Keep anticipated rewards small.** Monthly salaries are anticipated, of course. However, since workers receive their salaries whether they achieve good results or not, this anticipation will not interfere with their stress levels and performance.

3. **Reward continuously, not once.** The merit system has a regular cadence because workers reward each other frequently. Feedback is not put off until the end of the year; therefore, the chance of forgetting things is small.

4. **Reward publicly, not privately.** In the ideal version of this practice, the hugs are earned publicly. Transparency makes sure that everyone knows what is going on, and what is appreciated by others, so they can adapt accordingly.

5. **Reward behavior, not outcome.** People will give hugs for the things that they did for each other and for the organization. This rewards behaviors. The final outcome will depend on the environment, and people cannot be made responsible for that.

6. **Reward peers, not subordinates** Management switches focus from managing the earnings of people to managing the constraints of the system. The recognition that people get is from peers, not from management.

Like any useful recipe, the rules for rewards should be considered as guidelines, not laws set in stone. Nevertheless, it is encouraging to see that our merit system is in line with these guidelines. Particularly, since they were derived from motivational literature.

But...
thinking about money is distracting!

Correct, but *someone* has to do it. Not paying workers any money is not an option. They are creative networkers, not unpaid volunteers. Paying everyone the same amount all the time is also not an option for various economic reasons. A moderate level of income fluctuation is necessary to keep the system anti-fragile. So, who will decide *how* the money flow in the system will fluctuate?

Simply thinking about money has an influence on people's behaviors. [Kahneman, *Thinking, Fast and Slow* pag:55] Therefore, it is tempting to leave this dreaded responsibility to one manager so that everyone else can "just focus on the work". Of course, what usually happens is that, besides focusing on their work, people are complaining about their compensation and how badly the manager is doing his job. After all, everyone feels entitled to more!

Shifting responsibility for the money flow to the workers, through the use of a peer recognition system is similar to introducing capitalist democracy. We can discuss all the risks and dangers of this system and how to improve it, but there's one thing we can agree on: it will probably work better than getting paid as if through a dictatorship.

Experiment and Customize

The system described in this chapter is a generic practice for earnings based on merits. It can (and should) be customized in many different ways. For example, instead of ***hugs*** or ***beans***, the creatively challenged organizations may prefer a term such as ***credits*** or ***points***. And instead of a fully open process, the transparently challenged organizations may want to keep part of the process anonymous and reveal only a small part of the results to the participants (such as the "top 10 recognized people in the organization"). The system can also be introduced gradually. At first, you could do this for a small part of the traditional bonus. Later, with more experience and more buy-in from employees, you can increase the percentage and the impact of the system.

Money and emotions are tricky things; therefore, any system that involves both will have to be set up in a way that is safe-to-fail. With small increments (such as weekly or monthly experiments instead of quarterly or annual outcomes), the feedback cycle is shorter and people will learn faster how to improve the system. The use of a valueless virtual currency instead of real money will allow people to experiment more comfortably; it will be easier for them to decide that a chosen path is not working and change direction, or start from scratch. We must also realize that creative people ***will*** game the system. The trick is to exploit this creativity to make the system more resilient. The short iterations and valueless currency should help people to adapt to each other's strategies, and allow management to tweak the constraints, all in favor of increasing collaboration and working towards a common purpose.

When central authority is replaced with distributed decision-making, things can and will go wrong. One only needs to consider the countries where a dictatorship has been replaced with a democracy. This is rarely a straightforward process. Likewise, switching from a traditional bonus system to a merit-based bonus system will probably involve the need to address a number of problems. I received some reports about employees making deals with each other, about cheating leading to more cheating, and about rewards being given for unhealthy behaviors. If you ask me how to ***prevent*** these problems, I will tell you that you can't. I can only suggest that you set up a system that is safe-to-fail, and that you learn what other organizations do to make things better. This is similar to the way democracies learn from each other how to have better elections and better institutions. After all, the only alternative is either dictatorship or anarchy.

Creative people will game the system. The trick is to exploit this creativity to make the system more resilient.

Finally, it is hoped that the merits market described here will grow into a more collaborative culture within the organization. But one thing is certain; when recognition of merits (and allocation of money) is transferred from management to workers, it absolves management of performance reviews and bonus calculations. This means that managers can start leading and servicing people, instead of managing everyone's money. [Markowitz, "3 Weird, Game-Changing Ways to Make Employees Happy"]

What if...?

In various discussions I have had about the merit system, people are always positively interested, while at the same time being genuinely concerned about several variants of the "What if" question:

- "What if two people decide to give each other all their hugs?"
- "What if people demand hugs in return for good behavior?"
- "What if extroverts get more hugs than introverts?"
- "What if people are just pretending to be interested in collaboration?"
- "What if intrinsic motivation is destroyed when someone gets no hugs?"

I don't have ready-made answers to all these questions. The way I see it is that any merit system has flaws that will surely come to the surface; nevertheless, it will always be better than the dysfunctional financial reward systems most organizations have institutionalized now. Why worry too much if a new system might demotivate 10% of the people, when the current system demotivates 90% of them?

With simple rules, fair governance, and sufficient transparency, people will be able to adapt to each other's behaviors (both the good ones and the bad ones). Ultimately, the only remedy to self-organized misconduct and emergent unfairness will be the positive creativity of peers, not the addition of extra rules and procedures. The best way to deal with problems is to turn the financial stuff into a real complex adaptive system.

A crazy idea that works

"I am the CEO at Fonte Medicina Diagnóstica, a molecular pathology center that deals with cancer tests. One of the problems I ran into as a new CEO was our salary system. In my opinion, the people that made the most effort should be entitled to some extra money, but I had no idea how to measure employee performance. One of the company's key values is collaboration and I wanted this to play an important role in our compensation system.

For a while we had a bonus system based on 360-degree evaluations, but that process took way too long. We then decided to implement a merit money system. Every month everyone at the company receives the same bonus with a fictional currency. There's just one rule: you can't keep the money for yourself. You can give it all to the same person or you can distribute it in small amounts. Can't think of someone? Just give it away next month. As a manager, I can only see part of how people are performing. But with this system, employees decide for themselves whether their peers do their jobs well. We also have a trade market with a conversion rate. People can choose to exchange their fictional currency or keep their money and wait for a better rate.

I now have far fewer things to deal with. All kinds of arguments and other things that I needed to handle have now appeared to solve themselves. People just know good behavior will pay off. Dysfunctional behavior will be dealt with: you won't get any extra money. The best part is, I explained it to the people in 30 minutes and it worked right from the start!" (adapted from Happy Melly, "Merit Money: A Crazy Idea That Works")

Cláudio Pires, *Brazil*

It couldn't possibly work

"I didn't like the idea at first. I actually wrote downright hate mails about it to my boyfriend, complaining about how it couldn't possibly work. Since I can't judge everyone's input, I thought it wouldn't be a fair way to judge the team. For instance, I don't know whether my team member Sergey writes good code because I'm not a programmer myself. But after giving it a try, I changed my mind.

Now I actually like the system very much. It really works because we complement each other: we rate each other on different aspects of our work. Plus, I am more motivated to communicate about what I'm doing with my team. And although I don't know if Sergey's code is good, I can judge Sergey on whether he's a good team member—for me that's enough. Someone else can judge the code if he wants to." [Happy Melly, "Merit Money: How to Make Your Employees Define Their Own Compensation"]

Lisette Sutherland, *The Netherlands*

Cashing stars

"I've seen a practice similar to Merit Money at a client's business in Romania. They have two visual boards: on one board there are the pictures of all company members (roughly 20). On the other board they have a catalog that lists various physical items, starting with a pack of beer and going all the way up to a PlayStation. Other artifacts include books, monitors, or fancy office chairs. Each physical item has a price in stars: 1 star for the pack of beer up to 100 stars for the PlayStation.

During each project, whenever a team member feels a colleague helped him, he is free to award a star to that colleague. There's no limit imposed by management on the number of stars you can award. At any time, the team members can 'cash in' their stars by asking management to purchase the desired physical item for which they have enough stars. The CEO told me that, initially, he was afraid people might exploit this system unfairly, but in fact nothing like that happened. Nobody abused the system and everybody acted like a trustworthy adult."

Flavius Ștef, *Romania*

A justice system

At Cocoon Projects each governance task has a value in credits, which is estimated by all the participants of that activity and averaged by our software system. After task completion and acceptance, all the participants evaluate how much value (not time or effort) each person has contributed to the final result. The system averages the results for each participant and the credits earned are directly converted into financial compensation. The system then returns two transparent values: the final averaged shares percentage of that activity for that participant and the distance between this value and the percentage the participant evaluated for herself.

Surprisingly, in the years we've been using this system, we have observed an amazing sense of 'justice' triggered by it. People know very well how much they contributed in the creation of value. The rest of the job is done by the transparency and reputation dynamics and, ultimately, by the common culture that such a system fosters.

Jacopo Romei, *Italy*

What now?

Let's see if your organization is ready to introduce its own merit system.

1. With this practice, it is very important that you first create a safe-to-fail environment. For example, announce the new program by saying that you will first want to gain experience through a trial period of a couple of iterations, and that you will surely do a reset of the whole system after that period.

2. Think of the logistics, such as the name of the virtual currency and how it will be awarded. Will it be introduced physically or electronically? Can people reward entire teams and business units? How much of the system will be transparent?

3. Get commitment from key leaders in the organization. Allow people to get involved voluntarily, so that they can first watch the effects on other people and on the business as a whole.

4. Evaluate the trial period with all stakeholders before doing a real introduction.

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