
# Merit Pay:
# An Obsolete Policy?

**CEO Publication**
**G 80-1 (1)**

Edward E. Lawler III
Center for Effective Organizations

May 1994

# Merit Pay:
# An Obsolete Policy?

**CEO Publication**
**G 80-1 (1)**

Edward E. Lawler III
Center for Effective Organizations

May 1994

Center for Effective Organizations - School of Business Administration
University of Southern California - Los Angeles, CA 90089-1421 (213)740-9814

# MERIT PAY:
# AN OBSOLETE POLICY

by

Edward E. Lawler III

G 80-1

ABSTRACT

This paper looks at the problems with merit pay. Specific emphasis is on why salary increases typically are poor motivators. It stresses that bonuses are often a viable alternative to salary increases.

# MERIT PAY: AN OBSOLETE POLICY?

By Edward E. Lawler III

The idea of merit pay or pay for performance is so widely accepted that almost every organization says that they have a merit pay system. Even the U.S. Government calls their system a merit pay system and recently, legislation (the Civil Service Reform Act) was passed that calls for the system to be more dependent on merit. The major reason for the popularity of merit pay is the belief that it can motivate job performance and increase organizational effectiveness. The research evidence clearly supports this view. It shows that pay can be a motivator of effective performance when it has two fundamental properties. First, it has to be important to people; second, it has to be tied to their performance in ways that are visible, creditable, and perceived by them to be direct (see e.g., Nadler and Lawler, Reading XX, Lawler 1971). For most people, pay is important, so typically this is not a problem in using pay as a motivator. The critical issue is whether a perceived relationship exists between pay and performance.

Despite the existence of widespread support for the policy of merit pay, there is considerable evidence that in most organizations merit pay systems fail to create a perceived relationship between pay and performance. As a result of this failure, they also fail to produce the positive affects which are expected of them. In addition, there are some reasons to believe that in the future, it is going to be harder to have effective merit pay programs. But before we consider what the future holds, a brief review of the reasons why merit pay systems often do not

produce the perception that pay and performance are related will serve to highlight the problems in using pay as motivator of performance.

## PROBLEMS WITH MERIT PAY SYSTEMS

### Poor Performance Measures

Fundamental to any effective merit pay system are objective comprehensive measures of performance. Without these, it is impossible to relate pay to performance. There is a great deal of evidence that in most organizations, performance appraisal is not done well and that as a result, no good measures of individual performance exist (see e.g. Meyer, Reading XX and Kerr Reading XX). Sometimes good measures of plant or group performance exist but often, even these are not adequate, because they do not measure all aspects of performance. In the absence of good objective measures of performance, most organizations rely on the judgments of managers. These judgments are often seen by subordinates as invalid, unfair, and discriminatory. Because the performance measures are not trusted when pay is based on them, little is done to create the perception that pay is based on performance (Meyer et al. 1965, Kane and Lawler 1979). Indeed, in the eyes of many employees, merit pay is a fiction, a myth that managers try to perpetuate.

### Poor Communication

The salaries of many individuals in organizations have traditionally been kept secret. In addition, some organizations keep many of their pay practices secret. For example, it is common for organizations to keep secret such things as how much was given out in salary increases or bonuses and what the highest and lowest raises were. Thus, the typical employee is often in the position of being asked to accept as an article

of faith that pay and performance are related. Given secrecy, it is simply impossible to determine if they are.

In situations of high trust, employees may accept the organization's statement that merit pay exists. However, trust depends on the open exchange of information and thus with secrecy, it is not surprising that many individuals are mistrustful. In a significant number of organizations, the communication situation is worsened because the organizations either don't spend the time or energy needed to explain their system, and/or they communicate in words that lead people to question the creditability of the system. For example, organizations often state that all pay increases are based on merit, even though virtually everyone gets an increase because of inflation and changes in the labor market. Given this, it is hardly surprising that individuals often question how much merit had to do with their "merit increase."

Poor Delivery Systems

The actual policies and procedures which make up a merit pay system often lead to actions which do little to actually relate pay to performance. In addition, the policies and procedures often are so complex that they do more to mystify and obfuscate than to clarify the relationship between pay and performance. The typical merit salary increase is particularly poor at actually relating pay and performance, because it allows only small changes in total pay to occur in one year. It further compounds the problem by making past "merit payments" part of the individual's base salary. This means that an individual can be a poor performer for several years, after having been a good performer, and still be highly paid. Bonus plans typically are better at relating pay to

performance, but they are sometimes flawed by policies which fund them at such low levels as to be insignificant and by procedures which lead everyone to get the same bonus.

Poor Managerial Behavior

Managers do a number of things that negatively affect the perceived connection between pay and performance. Perhaps the most serious is the failure to recommend widely different pay increases or bonuses for their subordinates when large performance differences exist. Some managers are unwilling to recommend very large and very small pay actions, even when they are warranted. One reason for this seems to be the unpleasant task it leads to of explaining why someone got a low raise or bonus.

The difficulty of explaining low raises or bonuses often leads to a second very destructive behavior on the part of managers: disowning the pay decision. Despite the fact that they may have made a recommendation for a small raise and believe it is appropriately given, supervisors sometime deny or discount their role in determining their subordinates' pay. They may, for example, say that they fought hard for the subordinate to get a good raise but lost out. This clearly communicates to the subordinate that pay increases are beyond their control and thus, not based on performance.

Conclusion

The existence in most corporations of any one of the common problems which plague the administration of merit pay programs is usually enough to destroy the belief that pay is related to performance in the eyes of most employees. In reality the merit pay systems of most organizations typically suffer from all or most of these problems. As a result at best,

the policy of merit pay fails to achieve its intended objectives, at worse it becomes an embarrassment which undermines management's credibility.

## FORCES ACTING FOR AND AGAINST MERIT PAY

Given the rather questionable history of merit pay, is there any reason to believe that things can or will get better? Putting aside for the moment the issue of whether they can get better, let us first look at the forces and trends that are operating in the environment which threaten merit pay and those which favor it.

The list of trends and forces acting against paying for performance is long. Taken together, they make a rather impressive and depressing list for those who believe that pay and performance should be related. Let me briefly review them:

1. Inflation. More and more organizations seem to be falling into the practice of simply giving across-the-board increases in order to keep everybody whole in periods of high inflation. This of course, serves to keep people from losing real income, but it fails to relate pay and performance. The problem can be compounded by government wage control programs. With the limited amount of money available because of controls, many organizations seem to feel obliged to give it out equally--because there is such a limited budget, and inflation is effecting everyone so negatively.
2. Organization Size. In large organizations, it is often particularly difficult to tie pay to performance. Size can mean that many jobs are created in organizations that don't have a direct interface with the external environment, and therefore don't have clear performance goals and measures. Needless to say, as performance becomes more difficult to measure, so does tying pay to it.

3. Production and Service Organizations. There is a clear tendency for more and more jobs to fall into the service sector and into organizations with a process technology (e.g., chemicals, oil, food). This represents a serious problem for tying pay to performance because, usually, it is more difficult to measure performance in service and process production organizations. Just as was true with the impact of organization size, as performance becomes more difficult to measure, it's less likely to be done, and pay is less likely to be related to it.

4. New Forms of Organizations. During the last decade, we have seen an increasing growth of new forms of organization. Probably, the leading one is the matrix structure. There are a number of advantages to matrix structures, but one of them is not in the area of tying pay to performance. The matrix structure tends to make it more difficult to measure individual performance and as a result, to tie pay to it. The problem with measuring performance in matrix structures is one of clarifying who is to do it and what criteria are to be used.

5. Benefits Growth. The strong push for benefits by unions has had, and promises to continue to have, a negative impact on the cash available for merit pay. Most organizations have a tendency to pass on whatever benefits they give to their unionized employees. As a result, compensation dollars which could be spent on merit pay, end up getting spent on fringe benefits, many of which some people do not even want. The impact of this, of course, is to reduce further the tie between pay and performance, because the cash simply isn't

available to distinguish between the better and worse performers. Interestingly enough, this problem occurs even in nonunionized companies. The tendency there is to give everybody union-type benefits in order to prevent union organizing drives from succeeding.

6. Due Process/Employee Rights Consciousness. There is clear evidence that employee expectations concerning due process and public accountability in decision making are increasing. Further, there's evidence that individuals, when they feel unfairly treated and denied due process in the area of salary decisions, are willing to go to court. One answer to this is to move toward open decisions, public accountability, and appeal processes, but the more this occurs, the more some managers seem to back off from making tough decisions that will reward performance. Another way of saying this is that the more managers are held accountable for their pay decisions, the more they tend to fall into the homogeneous treatment of individuals in order to avoid the discomfort of defending differential treatment. In the past, of course, this discomfort might only have been interpersonal discomfort in confronting an unhappy subordinate. Today, it may involve court appearances, financial losses for the organization, and considerable loss of face for the manager. The result is that more and more managers seem to be thinking two or three times before they withhold a pay increase.

7. Performance Appraisal. The more we study performance appraisal, the more we seem to be able to identify all the problems and difficulties with it. Unfortunately, we don't seem to be able to improve the

state of the art proportionately. The result is that many people who work with performance appraisal systems are rather depressed about the ability of performance appraisals to result in valid measures of performance. Given this, it is difficult to argue strongly for using subjective appraisals of performance as a basis for establishing a pay performance link. This of course, is not a problem where objective measures are available, but in many situations, objective measures of performance simply are not available.

8. Mistrust of Large Organizations. Recent survey data has shown that more and more people mistrust managers and mistrust the reward systems in the society. Stated another way, they're less likely to feel that good performance will lead to rewards and that the managers of organizations are doing a good job and can be trusted. Given this, it is likely to be more difficult in the future to convince people that in their particular work situation, pay and performance are related. They may have to see much more dramatic evidence than they have in the past when the prevailing belief was that in the American society, hard work paid off.

Overall, the future of merit pay looks pretty bleak, indeed, worse than in the past. At this point, you might expect a conclusion that we should forget about the whole idea of merit pay and concentrate on keeping pay rates equitable in order to attract and retain the best employees. In some situations this may be the best approach, but the situation for merit pay is not all negative-there are some positive trends that need to be mentioned.

1. Need for Performance Motivation. More than ever, organizations need the performance motivation that can be generated when pay is successfully tied to performance. Many organizations face tough international competition, and they have to deal with a workforce that is new and different in a number of important ways (e.g., values, education, demographics). Clearly, paying for performance can't solve all the motivation problems associated with the new workforce and strong international competition. However, it can be an important part of a total management system which is designed to create a highly motivating work environment, and the realization of this fact makes continuing efforts to develop effective merit pay systems both likely and important.

2. Inflation. Inflation doesn't have to be a negative force as far as tying pay to performance. It can be a strong, positive force because it generates a larger pool of money for pay increases. Because a larger pool is present, the possibility exists of substantially differentiating people in the amount of increase that they get. For organizations that have not paid for performance in the past, it can represent a unique opportunity to get their total compensation levels more in line with performance. In some respects, it's harder to make these differentiations when the failure to get an increase means a loss in real income for the individual, but for an organization that is strongly committed to paying for performance, inflation can provide an opportunity to tie pay more closely to performance.

3. Values. There is a continuing belief on the part of the American workforce that pay should be related to performance. Despite the fact that there's a growing mistrust of the way rewards are distributed in society, there is no evidence that the historically strong belief that pay and performance should be related is going away. Indeed, in my surveys, employees at all levels in organizations still state that they think people should be paid for their performance and that pay for performance is a valid principle for salary administration (see e.g. Lawler, 1981). They typically also see a large gap between the degree to which they are related and the degree to which they feel they should be.

4. Information Systems. The growing sophistication of many management information systems can be a positive force in relating pay to performance. It can help make up for many of the inadequacies of today's performance appraisal systems and, as such, increase the validity of pay for performance systems. For this to happen, management information systems must be developed that will allow individual and/or group performance to be measured in a way that allows pay and performance to be related. What is needed is a set of comprehensive, objective measures that account for the variance in performance which are under the control of the individual or group. Systems which measure things that cannot be controlled are not particularly helpful in this respect.

5. Decentralization and Diversification. The tendency of many large organizations to decentralize and to diversify can provide a real basis for improving the relationship between pay and performance.

Both have the effect of breaking up the organization into a number of mini-enterprises. This allows for better measurement of group, unit, and sometimes individual performance and this, in turn, makes it more feasible to relate pay to performance, because it improves the organization's ability to measure performance in objective and valid ways.

6. Openness/Participation. Some organizations have combined more openness and employee participation with better pay for performance systems (Lawler, 1981). This is not a necessary or inevitable consequence of openness and participation, but it is a possible one when the openness and participative process is handled effectively. In some organizations, in fact, peer groups measure performance and determine rewards in an open discussion. Interestingly enough, in cases where this has been tried, it has often proved to be more effective in relating pay to performance than the typical one-on-one superior-subordinate pay administration decision process. Peers have better information and when they are motivated to do a good appraisal, can often do a better appraisal and make better judgments than the supervisor can alone.

7. Importance of Pay. Finally, it is worth noting that there is survey research evidence that pay is becoming more important to people in the American society (see e.g. Quinn and Staines, 1979). This means that efforts which do successfully tie pay to performance are likely to pay off in the area of motivation, since the more important pay becomes, the more motivational potential it has. There is no convincing evidence as to why pay is becoming more important, but

it's not hard to guess. With inflation eroding incomes, people are becoming more dissatisfied with their pay, and there is considerable evidence that when people become more dissatisfied with their pay, it becomes more important to them (Lawler, 1971).

## MERIT PAY IN THE FUTURE

What should organizations do in the future with respect to merit pay? One clear implication of the discussion so far is that they should not automatically say that they have a merit pay policy. It seems clear that the concept of merit pay has been bought by a number of organizations, without their being aware of what is needed to make a merit system work. Full exploration of whether it fits should lead a number of organizations to conclude that it doesn't fit all or part of their operations. For them, it is obsolete and should be abandoned, a step which could have some very positive results. At the very least, it should increase the credibility of management. It may also serve to eliminate unneeded superior subordinate conflicts and to save administrative time. For those that decide to have merit pay, the following points warrant serious consideration.

1. The possibility of using a bonus system or systems should be examined. As a delivery system, they have a number of advantages, and there is increasing evidence that bonus plans of a number of different types can be effective. There has been a recent increase in the use of bonus systems at the top management level and at the plant level, but they still seem to be underutilized. Particularly underutilized are group and plant level gain sharing systems like the Scanlon plan, the Rucker plan, and the Lincoln Electric plan. All

too often, organizations have tried piece rate pay plans, have found them to be unacceptable for a number of reasons, and had abandoned the idea of tying pay to performance through bonus type plans. Group plans and plant level plans are an entirely different type of plan than are individual piece rate plans, and as a result, they can work when piece rate plans cannot. Indeed, going back to the problems in tying pay to performance that were mentioned earlier, many of them are not problems in group and plant level plans-primarily because larger aggregations of people (e.g., a total) often allow for better performance measurement. Recognizing this, a number of large companies have installed multiple gain sharing plans (e.g., General Electric, Midland Ross, Dana and TRW).

2. Attention needs to be paid to the process involved in merit pay issues. A good delivery system is important in any merit pay plan, but so are good communication policies and proper decision processes. Without these, the best merit pay system will fail because employees will not see the relationship between pay and performance. This point is particularly pertinent in light of the changing nature of the workforce. It is quite possible that in the future, due process and open communication will be necessary, if merit pay systems are to operate at all. The evidence on participation in pay decision suggests that the use of participation can make decisions more creditable (see Lawler, 1981). In any case, considerable attention needs to be devoted to a description of the system and to correctly identify what is and is not a merit salary action.

3. Performance appraisal must be taken seriously. In order for appraisal to be effective, people need to be trained, systems developed, and time spent by both the appraisor and apraisee. Having an untrained appraisor spend a few minutes reviewing the performance of a subordinate, and then making pay recommendation simply is not acceptable. Performance measures need to be mutually agreed to, results jointly reviewed, and pay action discussed. If these practices are not acceptable or possible, then merit pay should not be based on performance appraisal results.

4. Attention needs to be focused on key organizational factors which affect the pay system. Often a poor merit pay system is a symptom of other problems and cannot be improved until they are solved. It is impossible to have an effective merit pay system, if, for example, jobs are poorly designed and an organization is poorly designed. With these conditions it is simply too difficult to measure performance and assign responsibility for it. Similarly, without a good information system in place, it is often impossible to validly measure individual performance.

## SUMMARY AND CONCLUSION

To summarize, it is going to be more difficult to administer merit pay systems in the future. Organizations are becoming more complex, society is more complex, and the workforce is more demanding. But it is also more important than ever that appropriate pay should be tied to performance. Finally, there is reason to believe that calling a pay plan a merit pay plan and then not delivering will become less and less acceptable. Taken together, this suggests that some organizations need to

partially or completely abandon their merit pay plans, while others need to invest heavily in making theirs more effective.

## REFERENCES

Lawler, E. E., Pay and Organizational Effectiveness, New York; McGraw-Hill, 1971.

Lawler, E. E., Pay and Organization Development, Reading, Massachusetts, Addison-Wesley, 1981.

Meyer, H. H., Kay, E. and French, J. R. R., Split Roles in Performance Appraisal, Harvard Business Review, 1965, 43(1), 123-129.

Quinn, R. P. and Staines, G. L., The 1977 Quality of Employment Survey, Ann Arbor, Michigan, Institute for Social Research, 1979.