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**PAY FOR PERFORMANCE:
DOLLARS AND SENSE**

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Abstract

Guidelines are proposed that should be followed in developing pay for performance plans. They emphasize putting significant amounts of money at risk, a focus on performance measurement, and making it clear to all employees how pay for performance plans work.

PAY FOR PERFORMANCE: DOLLARS AND SENSE

Paying for performance is an idea whose time has once again come. Virtually every recent survey of pay practices shows that organizations are dissatisfied with their current pay systems and are making efforts to improve the relationship between pay and performance. The idea of paying for performances has been an important part of the American business culture for decades and at times, various government agencies have subscribed to it as well. It seems to have more lives than the proverbial cat with nine, and is as American as baseball and apple pie.

It is not hard to understand why the idea of pay for performance is so attractive. First, it appeals to the basic American sense of justice. Attitude surveys shows that the American public believes that people should be rewarded according to their contribution because it is fair, right, just, and equitable. Second, pay for performance is appealing because of its potential contribution to organizational effectiveness. The most frequently mentioned advantage of paying for performance is increased motivation. Virtually every scientific and common sense approach to motivation argues that basing pay upon performance should produce greater motivation. But the potential advantages of paying for performance do not stop with motivation. It has also been argued and established that it can be critical in retaining high performing employees, building an entrepreneurial culture, and focussing the efforts of employees on critical business objectives.

As is true with many business practices, pay for performance sounds better than it plays in most organizations. Time after time, organizations install pay for performance system with high hopes and

objectives, but end up with systems that have poor credibility and at times are counterproductive.

The reasons organizations have great difficulty operating pay for performance systems are many and complex. It is not a simple task to establish a pay for performance system. They are complex, multi-faceted features of an organization, and to be effective must fit with and be supported by other organizational practices. As with most organizational practices, what works in one organization may not work in another. There are, however, some general rules about performance pay that can guide organizations in establishing systems. Violating them doesn't guarantee failure and they don't have quite the same status as the Ten Commandments. Nevertheless, I am convinced that they are valuable guides to designing and managing effective pay for performance systems and to violate them is to greatly increase the probability of failure.

Think Big

A pay for performance system must pack some whallop. That is, the amount of money at risk must be large enough to be important to individuals. Everything we know from motivation theory says that motivation is dependent upon the attractiveness of the reward. It turns out that material things are valued in proportion to their size and financial value. Not surprising, large amounts of money are valued more than small amounts and are thus likely to be more motivating.

The value of any given amount of money is influenced by the amount of the reward the individual already has. The more an individual has the less a given increment will be valued. The implication for pay systems is very clear. In a pay system, if a reward is to be valued by

people, it needs to be large in proportion to the amount they already receive. Research suggests that a pay change of 3 to 4 percent represents a noticeable increase, however, a pay change probably needs to be 10 to 15 percent to be important enough to make a significant difference in motivation.

It also helps the importance of a reward if the reward amount is made public and recipients are selected in a credible and valid way. These two features are important because they are what makes the difference between a financial reward which conveys status and prestige and one which does not and therefore is valued only for its monetary value.

Avoid Salary Increases and Other Annuities

Since pay rewards are expensive, organizations have only a limited ability to give them. Thus, they need to carefully spend their dollars in order to maximize their positive effect. Despite this, most organizations deliver monetary rewards through salary increase systems. The problems with merit pay and salary increases are many, perhaps the chief one being that past increases become annuities that are no longer available to use as rewards and motivators. Once an individual gets a reward, it is virtually impossible to take it away. In low inflation times this means that an organization's ability to reward someone with a large pay increase is very limited. A 4 or 5 percent increase is typical and for the most outstanding performer, a 7 or 8 percent increase is all that can be given, hardly enough to send chills of excitement through a workforce.

Fortunately, there is an easy way to overcome the problems associated with merit increases, eliminate them. If an organization

feels it must move an individual's base salary to keep pace with the market it can do this, but it shouldn't confuse this with rewarding performance.

Use Bonuses

Performance should be rewarded through some type of variable or bonus pay system. Bonuses should be awarded on a regular basis and should be tied directly to performance during a specified performance or time period. At the lower pay levels in an organization the bonus probably should vary up to about 20 percent of salary. At the top of the organization it should vary by much more. With a bonus system, all variable pay should be at risk each performance period so that a continuing motivational impact exists. A bonus approach eliminates the problem of people getting to the top of their pay range and, as a result, having little pay at risk. Further, individuals are not sentenced to the bottom of the pay range for their job just because they are new in the position. Good performers can be immediately moved to the top of the pay range and poor performers can be at the bottom regardless of their seniority and history. This is crucial in retaining the best performers because it takes higher pay to keep them.

Reduce Benefits and Eliminate Perquisites

Benefit programs and perquisite programs are very similar to salary increases. From a motivational point of view, money spent on them is money misspent. It takes money that potentially could be tied to performance and puts it into a form of annuity. Fringe benefits are virtually impossible to disturb based on performance as are perquisites. Typically, both are based on management level, seniority and base pay,

thus they end up rewarding things other than performance. As a result organizations get little in return for the money spent on them. They are also a poor way to spend money since they are often undervalued relative to their costs by the employee's who receive them. In short, all too often organizations end up spending valuable dollars on benefits and perquisites that are undervalued and that do nothing for their ability to reward and recognize performance.

The More the Better

At the executive level organizations typically have multiple pay for performance plans. However, at other levels they rely solely on their merit salary systems to reward performance. In some respects this is just the reverse of what makes the most sense. Pay for performance is needed more in lower level jobs than at the executive level since the work itself is not as motivating there. As a result, pay needs to be a particularly important source of motivation.

The best strategy is to create multiple pay for performance systems at the lower levels of an organization. Creating an environment in which performance is measured and rewarded in multiple ways reflects the realities of how organizations work. Organizations measure themselves in terms of division performance, corporate performance and so on. Given this, it makes sense to reward individuals based on these same kinds of measures. Employees can and should participate in stock ownership plans, profit sharing plans, local gain sharing plans, and perhaps, individual pay for performance plans. Finally, it is often useful to have a spot award that can be used to deliver an immediate reward for effective behavior.

When creating multiple pay for performance systems it is important to develop an overall reward system structure. This structure needs to identify where pay for performance systems fit and to specify how each individual's total compensation will be affected by their personal performance as well as their units and organizations performance.

Sooner is Always Better than Later

The most motivating rewards are those that closely follow the desired behavior. This suggests that organizations need reward systems that operate on a frequent basis. Instant or spot rewards are one good example of this. In a number of companies today supervisors can give cash, dinners or other rewards when someone does something exceptional. This type of reward is particularly effective because it can be tied directly to positive behavior. Gainsharing plans offer another device that can tie reward directly to behavior. These plans can pay off as often as every week and as result, are quite powerful as motivators.

Salary increase plans are a good example of plans which are not good motivators because of their infrequent impact. Some organizations which don't have much to spend on salary increases, stretch them over a long period of time so that they can be considered "large" increases. It is common to see raises given as much as 18 months apart. This makes sense from a cost point of view but makes no sense from a motivational point of view. How motivated can someone be by a reward that is 16-18 months off and has a maximum size of 8%?

You Can't Reward What You Can't Measure

The key to any successful reward system is effective measurement. Before the structure of a pay for performance system can be created, the

measurement issue must be addressed. Starting with the individual and working toward larger numbers of people, questions need to be asked about how to objectively measure performance, how effectively measures can be communicated and how much individuals can influence the measures. The ideal measures are those which are influential, objective, easily communicated and cover all the important behaviors that individuals should demonstrate.

The problem with many individual pay for performance systems is that performance can't be measured well enough at the individual level. This doesn't mean the organization has to give up the idea of paying for performance, however. Indeed in cases where individual performance is difficult to measure, it may be best to measure performance at the team level or at a higher organizational level. Better measures typically can be developed for teams and business units. Even though they are further away from the individual and are therefore less influential, an organization often is better off using them because it can reliably measure and reward the performance it needs in order to be effective.

If the decision is made to focus on individual performance, then a great deal of time and effort needs to be put into the performance appraisal system. The most common reason for the failure of individual pay for performance systems is the appraisal system. In order to make the appraisal systems work, the supervisor needs good interpersonal and feedback skills. In order to give a clear perception of how pay and performance are related the system needs to be clearly communicated. A preagreement is necessary between the supervisor and subordinate on how the appraisal system will operate and how it will affect pay. At the conclusion of the performance period the subordinate needs to be given a

chance to evaluate his or her own performance. Finally, the subordinate must be told how his pay was determined and how it compares to the way other individuals are treated.

Avoid Hierarchical Plans

Most pay for performance plans are hierarchical in nature. That is, they divide the organization into different management levels and create plans which are targeted at these levels. There are some good reasons why this is done. The point is usually made that people at the top of the organization have different responsibilities and should be measured in different ways. The problem with hierarchial plans is that they separate the organization into different interest groups. The result is that what is great for senior management may not be what is good for employees and vice versa. A prime example of this is golden parachute plans which often reward executives for bad management and turn the rest of the employees over to a new organization that subjects them to layoffs and pay reductions.

Because they create different interest groups, hierarchical plans can be very devisive. In addition, they put tremendous pressure on people to get on to the next higher level plan. As a result of the pressure and the difficulty of stating objective criteria for plan membership, the plans tend to be constantly changing their coverage. This is particularly true with management bonus plans which always seem to move lower in the organization than originally planned and then to be contracted because they have "lost their impact."

The alternative to hierarchical plans is to create plans which go from the top to the bottom of the organization. Although profit based plans may not have as much impact at the bottom as at the top, they can

help unify the organization. Other plans also can be extended to the bottom of the organization. For example, stock option and stock purchase plans, like profit sharing, can go from the top to the bottom. Gainsharing plans, of course, can cover all levels in a particular location or business.

Openness Builds Trust

The key to success for any pay for performance system is the belief that performance will be rewarded. For employees to believe this, they must trust their organization's statements that if they perform well they will be rewarded. Trust is not automatic in organizations, it must be established. In the case of pay for performance systems, one of the best ways to establish the credibility of the system is to openly show how it works. In the case of pay for performance, what is better than to show that better performers actually earn more money?

Despite the obvious advantages of openness, most organizations practice great secrecy. It seems as if they are embarrassed by their pay for performance systems and as a result do not want people to know exactly how they operate and who gets the best increases and bonuses. Secrecy, in addition to preventing trust from developing, can also have the effect of making the rewards less important. Rather than being a public recognition for something good, it becomes a secret event that is almost something to be ashamed of.

A good rule to adopt is that if you are doing something good, flaunt it, don't hide it. If you have to hide it, maybe you shouldn't do it! When you hide it, employees become suspicious about how effectively it is operating. As a result, when pay for performance is kept secret, employees often come to the conclusion that in fact it is

not operating effectively and that they cannot count on being rewarded if they perform well.

Participation Builds Trust and Understanding

One effective way to simultaneously build trust and understanding of pay for performance systems is to use participation. Historically, most pay for performance systems have been designed by staff and/or senior management and have been imposed upon lower level employees. The argument has been that lower level employees do not have the knowledge to design plans and cannot be trusted because their self-interest will cause them to make decisions which are not in the interests of the organization. Considerable experimentation with the design of pay for performance approaches shows that employees can be educated to do a good job in designing systems and can be trusted. Indeed, time after time, it has been shown that employees react very responsibly when they are asked to design pay for performance systems. Often they are more conservative in the amounts of money that they call for than are managers.

It turns out that when employees design their own pay for performance systems, they tend to understand, trust and believe in them more than when they are designed by others. Thus, widespread participation produces a double win. It leads to better trust and better understanding. In some cases it also leads to a third win, better design. Sometimes employees have important information to contribute to the design process and thus, when they are included, a better system emerges.

Overall: Take a Strategic View in Deciding What to Do

The effectiveness of any pay system ought to be judged by how much it contributes to an organization's strategic direction. The kind of behavior it motivates, the type of people it attracts and retains, and the goals that it causes people to focus on need to be looked at in assessing pay systems. The goal focus issue is a particularly critical one because focus on the right goals can integrate the organization in ways that are positive and constructive. A failure to produce a focus on the right goals can have the negative effect of dividing an organization into competing groups and preventing it from accomplishing its strategic objectives.

Organizations do not have to pay for performance, there are alternative ways to make an organization effective. Indeed many organizations would probably be better off if they did not employ their existing pay for performance systems. The systems are so flawed in design and administration that they often end up undermining the credibility of the organization and doing more harm than good. On the other hand, a well designed system can have significant, positive impacts. The challenge is to design a system that produces the right effects. Focussing on issues like communication, participation, reward frequency, and measurement can help an organization develop an effective pay for performance system.