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**PERFORMANCE APPRAISAL DRIVEN PAY**

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The judging of one individual's performance by another is a regular ongoing event in almost every human endeavor. On the surface it seems simple. One individual observes another performing a task and reaches a judgment about how adequately that task has been performed. The act of judging is a relatively simple one and one that occurs regularly throughout all human endeavors. The situation is substantially more complex in formal organizations than it is in most situations where performance judgments are reached. It is one thing for a fan at a sports event to observe the performance of a player, it is quite another for a superior to observe and judge the performance of a subordinate. The fan may provide feedback, of the vocal nature, but the fan has little reward power over the player and typically does not have an ongoing personal relationship with the player.

In an organizational setting the simple act of judging performance becomes immensely complicated precisely because of the potential impact of an appraisal judgment on other events. The appraisal judgment can be used to drive or influence a number of other systems in an organization. Indeed, it has often been said that performance appraisal judgments are at the very core of what an organization is all about. They provide information that can be used for control purposes, planning purposes and good judgments are at their core. Because of its central role and complex nature (as is shown in Table 1) performance appraisal can have both positive and negative effects.

It is precisely, because of the potential connections between the performance appraisal systems and other systems in an organization that performance appraisal is such a complex event. Indeed, it is the connections or lack thereof that often determine how effective the

performance appraisal system will be in the organization. They can contribute to an effective performance appraisal system that in turn can contribute considerably to organizational effectiveness. Alternatively, they can produce a performance appraisal system that is more destructive than constructive and that will significantly harm the organization.

It is impossible to predict how effective a performance appraisal procedure will be without understanding the degree to which it is connected to other systems. It is not simply a matter of understanding how the performance appraisal data influences such systems as the strategic planning process, the pay system and the career planning process. This certainly requires understanding, but research evidences suggest that in order to understand the performance appraisal event it is necessary to consider how the connections it has to other systems impact on the performance appraisal event itself. A reciprocal influence process occurs in which the performance appraisal system influences the systems it is connected to while they in turn influence the nature of performance appraisal events. Thus decisions about what to use performance appraisal for are not simply issues of how or whether performance appraisal can contribute to the pay system or the career system. They also raise the issues of how the connections will influence the nature of the performance appraisal system and whether this influence will have a constructive or a destructive effect on the performance appraisal process. The destructive effect may out weigh the advantages of connecting it to the system that it is driving.

This point is particularly important in considering whether performance appraisal should be tied to the pay system. Any consideration of whether the pay system should tie into the performance appraisal system

must look at both the positive (or negative) impact on the pay system of tying it to the performance appraisal as well as the negative (or positive) impact on the performance appraisal system of tying pay to it. Only when all these effects are considered is it possible to reach an overall conclusion about whether performance appraisal should be used to drive the pay system.

Unfortunately, there is no single model of how to connect the performance appraisal system to the other systems of organization. The correct design must flow from other features of the organization. In essence, the kind of connections that are developed must be based upon the characteristic of the organization and must fit the particular situation in which they are developed. This requires that the performance appraisal system developer take a diagnostic stance. The system developer must decide which connections are likely to result in a more effective organization based on such considerations as the way the organization is designed, the capabilities of the members of the organization and the objectives of the organization. This is particularly important when considering the connection between performance appraisal and pay.

Once we have considered the possible positive and negative effects of having the performance appraisal system drive the pay system, we will focus on those conditions which are likely to cause this to be effective. Finally, we will consider how pay and performance appraisal can be related.

#### Impact of Performance Appraisal on Pay System Effectiveness

Pay systems in organizations can accomplish a number of objectives. It's beyond the scope of this chapter to go into great detail about how and why they can impact on employee motivation, the culture of an organization and the attraction and retention of individuals. It is important to

stress, however, that strong evidence is available to support the contention that when pay and performance are related, individuals are motivated to perform more effectively, organizations develop performance oriented cultures and the attraction and retention of high performers is better. Overall then, there are a number of positive advantages that can come out of effectively tying pay to performance appraisal results. There are, of course, other ways to attract and retain good performers, motivate individual performance and create a performance oriented culture, but it is hard to ignore the possible positive impact of pay on these features of an organization. Thus, most organizations try to design their pay systems to reward performance.

Overall, then, if valid performance appraisal data are available then relating pay to performance appraisals results can make the pay system much more effective. There are no readily apparent negatives to this and a number of positives. The big "if" here concerns whether valid performance appraisal data are available. If valid data are not present then tying pay to performance appraisal results can lead to many of the negative consequences listed in Table 1. The pay system will become ineffective as a motivator as well as a possible source of discrimination charges, unwanted turnover and tremendous amounts of wasted time.

#### The Impact of Pay on Performance Appraisal

When the performance appraisal system is tied to pay, potential positive and negative impacts of the performance appraisal can occur. On the positive side, recent research evidence (Prince and Lawler, 198\_) suggests that when pay is discussed in the performance appraisal event both the superior and subordinate tend to take the appraisal more seriously and exchange better information about performance expectations and performance

results. The same research also suggests that individuals feel that pay and performance should be linked and that indeed they should be discussed at the same time so that individuals will have a chance to understand how the performance appraisal system affects their pay (see Chapter 2).

On the negative side there is evidence that when pay and performance are discussed little attention tends to be paid to long-term career development issues and to future performance concerns. Instead the conversation focuses on past performance and on the impact of performance on pay. There also may be a tendency for the subordinate to withhold negative information about his or her performance in order to look good during the performance appraisal. This can cloud the degree to which a valid performance discussion takes place and if the data are used for planning purposes it can have the negative effect of causing poor planning. In addition when individuals feel that their performance appraisal results are going to be used for pay determination purposes they often set lower goals and are more conservative in their estimates of what they can accomplish. This can have a negative effect on motivation because of the lower goals that are set. It also can have a misleading effect on the planning process since individuals have in essence provided misinformation to the planning process.

Perhaps the best way to summarize our discussion so far is to say that, when they are connected, the pay system puts certain stresses on the performance appraisal system. These stresses are not all negative but they do need to be taken into account in the design of any performance appraisal system. They also increase the risk of having the appraisal be a negative event.

Summary: Consequences of Relating Pay to Performance

When performance appraisal is tied to the pay system the impact on organizational effectiveness can be significant. A number of the positive consequences shown in Table 1 become more likely. But the situation does not stop there. If the performance appraisal is done poorly there's particularly likely to be a number of negative affects of tying performance appraisal to the pay system. Unless performance appraisal can be done well it is foolish for an organization to tie the performance appraisal system to the pay system. Positive advantages of relating it to pay are more than wiped out by the potential negatives of tying pay to a poorly done performance appraisal. This point leads directly to a consideration of conditions under which performance appraisal can be done well.

#### Determinants of Effective Performance Appraisal

There are a large number of factors which determine whether an effective performance appraisal is done. Some of the factors are situational in nature and are not a part of the appraisal system while some are part of this system itself.

A great deal has been written about how the forms and procedures surrounding performance appraisal should be developed and conducted in order to have effective performance appraisal systems. These issues will be dealt with later when when we consider the design of a performance appraisal system. At this point the focus will be on situational factors which determine the effectiveness of performance appraisal. Table 2 lists some of the key factors. It is extremely difficult to have an effective performance appraisal system when superior/subordinate relationships, job design and the culture are not supportive of effective performance appraisal. Let's look at each one of these in turn and see how they shape performance appraisal.



Job design is probably the single most crucial determinant of whether performance appraisal can be done effectively. Unless jobs are designed in ways that allow individual performance to be measured it is extremely difficult to do effective performance appraisal. Ironically, many of the job design characteristics which lead to effective performance appraisal are the same ones that are associated with effective individual job enrichment. As research on individual job enrichment has shown, when jobs are designed such that people can do a whole piece of work, have responsibility for performing that task and get feedback on their task performance intrinsic motivation is high. The same characteristics are also necessary in order for effective performance appraisal to be done for individuals. Indeed the feedback which comes to the individual and is key for intrinsic motivation is the same kind of data which needs to be used to appraise performance. In the absence of clear cut individual responsibility for a whole piece of work it is extremely difficult for the individual and for the supervisor to judge the individual's performance.

Effective performance appraisal also depends on open, effective communication between the superior and subordinate. In the absence of this kind of communication it is virtually impossible to have effective performance appraisal. Supervisors need to gather information from subordinates in order to find out how well the individual has performed in most cases and individuals need to gather information from supervisors in order to understand what performance is expected of them and how their performance is being judged. Thus, in absence of good superior/subordinate relationships and effective communication, it is extremely difficult to have a performance appraisal system which reaches valid conclusions about subordinates' performance.

Performance appraisal is a time-consuming and often difficult task to perform in an organization. It requires skills that many supervisors do not have and requires behavior on their part which is often difficult for them to demonstrate. Thus, considerable amount of support is needed if supervisors are going to engage in this behavior. The mere fact, for example, that negative feedback is sometimes required for the appraisal to go well means that some supervisors will be quite uncomfortable conducting the appraisal.

Because the appraisal is difficult to do it requires an organizational culture that is strongly supportive of doing performance appraisal effectively. The culture needs to be one where doing performance appraisal well is valued, where there are positive role models for effective performance appraisal and where the top of the organization takes performance appraisal seriously. In the absence of these positive cultural conditions, it is extremely difficult to do performance appraisal well. Thus, any consideration of whether pay should be tied to performance appraisal must consider the type of culture that the organization has concerning performance measurement and the degree to which the top of the organization will provide the necessary support and encouragement for doing performance appraisal effectively.

#### Substitutes for Performance Appraisal Driven Pay

Now that we've considered the possible impacts of relating pay to performance appraisal as well as the conditions that are necessary for doing effective performance appraisal we need to consider one last set of factors before deciding whether pay and performance appraisal should be linked. These factors have to do with whether other systems are available in the organization to do what can be accomplished by tying pay to

performance appraisal. If adequate substitutes are available for tying pay to performance then the organization may want to put less emphasis on trying to create a situation where the pay system and performance appraisal system are related.

In the area of motivation there can be adequate substitutes available for driving individual pay by performance appraisals. This is particularly likely in high participation work situations where work is designed for groups to perform. In this situation often the best measures of performance are at the group or organization level. This creates the possibility of having bonuses tied to group or organizational-wide performance. These can be an adequate substitute for individual performance appraisal-based pay because they also tie pay to performance. Admittedly they do not tie pay directly to individual performance and as such may not have as strong a positive impact on individual motivation. Nevertheless, they can provide an adequate substitute in the area of motivation and, of course, fit much better where work is designed for teams.

It is also possible that individuals in the organization are motivated by social goals as they often are in voluntary organizations. If this is true, then pay tied to individual performance may not be necessary. Indeed, it might be resented if it were done. Finally, it may be impossible in some organizations to even consider tying pay to performance because the pay budget to accomplish this is not available. It is not worth trying to tie pay to performance if there is little budget available for pay increases. As a result the net effect of tying pay to performance is an insignificant difference between the pay of good performers and the pay of poor performers.

Another substitute for tying pay to performance is a good goal setting process between the superior and subordinate. It has been shown that often goal setting can be motivating even though pay is not effected by the results of goal accomplishment.

In summary, decisions whether or not to tie pay to performance appraisal results need to explore the degree to which adequate substitutes for this are available. If they are available, they may be a more effective way to accomplish the same objectives.

### Making the Decision

Now that we have considered the potential advantages of tying pay to performance appraisal results, the conditions which favor it and the potential substitutes for it, we are in a position to make a final decision about tying pay to performance appraisal results. No formula exists which will allow this decision to be made in a highly programmed way. Indeed, there is never likely to be one. The situation is simply too complex. It requires tough judgment calls on the part of the system designers. There is a natural inclination for the system designer to choose to relate pay to performance appraisal results because of the important positive results which can come out of this. Quickly reaching the conclusion that this is desirable, however, is often a significant error.

As was stressed earlier, the potential downside of tying pay to performance is great and can far outweigh the positives. Even if performance appraisal is done as well as possible, tying pay to the results may have some negative effects since it can lead to less open communication and more conservative goal setting. Pay should be tied to performance appraisal results only where most of the favorable conditions for tying pay to performance appraisal exist and where adequate substitutes for this are

not available. Particularly important is the consideration of whether the conditions are right for doing effective performance appraisal. In the absence of strongly supportive culture, good job designs and adequate superior subordinate relationships it is not advisable to relate pay to performance appraisal results. If it is done without the right conditions not only will the pay system be rendered ineffective the appraisal system itself is likely to collapse under the stress of trying to support the pay system.

The favorable conditions do not necessarily all have to exist in advance of starting performance appraisal, but they do have to exist after the appraisal system is put in place. Thus, the system designer must make a decision as to whether the conditions can be created. Creating these conditions may involve a major organizational change effort and thus, it can be extremely risky to assume that they will exist once the performance appraisal system is put into place. To a degree sometimes the performance appraisal system can help move the organization in this direction but it is a high risk strategy to assume this will happen.

Overall then, the warning is clear. Don't be seduced by the potential advantages of tying pay to performance appraisal results. These results are available only if good performance appraisal can be done and this is by no means an easy thing to accomplish. A realistic assessment is needed of the situation to determine whether favorable conditions exist or can be reasonably expected to exist. In my own work I often use combination of attitude surveys, observations, and interviews to determine whether the right conditions exist or can be created. This step is missing in most design processes and as a result no realistic data are gathered on the potential for having an effective performance appraisal system. Not doing

an assessment is equivalent to entering unexplored territory without a map, something that only the foolish or extremely risk-oriented explorer does!

### System Design

The design of an effective performance appraisal system for driving pay begins with identifying the appropriate time period for the performance appraisal. Picking too short a time period runs the risk of having the measurement take place before the individual has had a chance to demonstrate the desired behavior. Picking too long a time period runs the risk of having the individual lose sight of the connection between pay and performance and thus, not be motivated by the results of the performance appraisal. Organizations typically pick a annual performance appraisal cycle, thus, everyone gets appraised once a year. At the lower levels of an organization this is probably too infrequent an appraisal cycle since the performance of people in these jobs typically is evident on a much shorter term basis than that. Indeed, at this level individuals often have left the job or the organization before the appraisal is due. At the top level, an annual cycle is too short, because in that time period individuals do not have a chance to demonstrate their performance effectiveness in the job. Often at the high levels a cycle of two years or more is appropriate.

Once the cycle for individuals in the organization has been identified the key issues become one of sequencing the events during the performance period. Table 3 illustrates the best sequence of events for most performance appraisal situations. It shows that at the beginning of the performance period specific goals and measures are agreed upon as well as the impact of accomplishing these goals on pay. In short, a performance contract is formed at this point that includes measures of performance

levels and pay results. It is particularly crucial that this discussion be a two-way one and that both the superior and subordinate feel that they have impacted upon the ultimate contract. If the subordinate does not see the goals as legitimate and does not understand the relationship to pay at this point much of the motivation impact of the process will be lost.

Many systems do part but not all of this process. That is, they agree upon measures of performance, but they do not discuss the issue of pay results. It is understandable why this occurs since talking about pay can be difficult but, if pay is going to be an effective motivator in the situation it is crucial that this kind of contracting exist. If it does not, the individual will be unlikely to understand the relationship between pay and performance.

Not shown in the table but potentially important is a mid-course review of the goals, objectives, and performance of the individual. Often, situational change makes the initial goals unrealistic several months later. In this case they need to be reset and adjusted to fit current conditions otherwise the motivational impact of the system will be lost. In addition, of course, sometimes on going feedback can help the individual correct the performance problems and accomplish goals that otherwise would not have been accomplished.

The table calls for two discussions at the end of the performance. The first is the individual's opportunity to present his or her perception of performance during the period. Research clearly shows that this step is important in determining whether the individual perceives the performance appraisal process as a fair and reasonable one. Often, this step is omitted and as a result, the individual feels that performance was appraised without adequate input and that the supervisor did not have the

correct information upon which to base the appraisal. As a result, the appraisal is seen as invalid and the individual fails to perceive the connection between pay and performance.

The final meeting is the one in which the overall performance of the individual is discussed and the pay action specified. Not shown in the table but expected to follow quickly is the actual pay action. Again, it is important that this pay action follow closely upon the final appraisal in order that a clear connection will be seen pay between pay and performance.

No specific mention is made in Table 3 of the type of form which is to be used. This omission is not accidental, but reflects the fact that no evidence exists that one type of form is superior to others. One point does need to be made however, whatever form is used should do two things. First, it should focus as much as possible on observable behavior and results. Secondly, it should give some quantitative score that can be translated into a pay action. One interesting possibility is to allow each pair of superior and subordinate to pick a form that they feel best fits their situation. In this approach the responsibility of the system designers would be to provide forms which are acceptable and if needed, to help the superior and subordinate pick the best one. This choice process could be quite effective since it should lead to their being committed to the way the appraisal is done and to using a form which fits their situation.

The careful appraisal performance system designer will notice that this sequence of paying performance includes no discussion of career and long term objectives. This is intentionally omitted from this sequence because it is assumed that this will be handled in a separate session on a



somewhat different timing cycle. As was mentioned earlier, research evidence currently shows that this series of events is best handled in a separate session because the discussion of past performance and pay tends to drive out consideration of career issues.

#### SUMMARY AND CONCLUSION

In summary, the decision concerning whether to tie pay to the performance appraisal system is a complicated one that warrants considerable study before the decision is made. The potential positive effects of doing it well are great as are the downside effects of doing it poorly. The performance appraisal system designers need to take a diagnostic role with respect to this decision. This means gathering data, analyzing the risks and ultimately deciding whether the advantages outweigh the disadvantages. In doing this there is no substitute for systematic data gathering and for the involvement of people who will be ultimately affected by the system in this diagnostic process. This means involving both potential administrators of the system and those individuals whose pay will be affected by the system. Without their commitment to a performance appraisal driven pay system, it is impossible to have the system operate effectively.

TABLE 1

Possible Effects of Performance Appraisal Systems

Possible Positive Effects

Motivation  
Performance Improvement  
Improved Job Definition  
Communication  
Superior and Subordinate Personal Development  
Subordinate Acceptance of Organization Goals

Possible Negative Effects

Legal Action by Subordinate  
Time Wasted  
Turnover  
False Data  
Worsened Superior/Subordinate Relationship  
Damaged Self Esteem  
Lowered Motivation/Performance

TABLE 2

Conditions Leading An Effective Performance Appraisal

Good job design: feedback, whole task enriched jobs

Supportive Culture: Rewards for how well appraisal is done, good role models provided by top levels managers, measures take of how well appraisal are done

Good Superior Subordinate Relationships: open communication, trust

high enough so that negative information can be communicated and good goals set.

TABLE 3

<u>Pre-Performance Activities</u>	<u>Initial End of Performance Period Activities</u>	<u>Final Activities</u>
1. Agree on performance desired	1. Subordinate input to appraisal	1. Communicate final pay action
2. Agree on performance measures	2. Superior react to input and give own views	2. Explain how pay action fits pay system and give information on how others were treated
3. Agree of how results will affect pay	3. Agree on final performance judgment and if possible at this time agree on pay action	