The Pay-For-Performance Bandwagon

In 2008 a growing share of employee compensation is likely to come in the form of pay-for-performance plans (PFP), part of a continuing trend to recognize and reward individual effort. We are all aware of the public criticism and increased regulation that have prompted companies to increasingly align executive pay with performance; less well known is that organizations have already been moving in that same direction for other segments of the employee population.

This makes good business sense, as companies strive to more effectively leverage limited reward budgets while striving to continuously motivate performance improvement in their employees.

A 2006 survey of 1,000 companies by Hewitt Associates found that 80% had some form of variable pay plan in place, continuing a steady increase in popularity over recent years. Meanwhile a 2006 long term incentive survey from Mercer Human Resource Consulting found that the prevalence of performance-based total rewards has risen in the last few years, from 4% in 2004 to 11% in 2006.

Deloitte reports that nearly two-thirds of the companies in their Top Five Total Rewards Priorities Survey plan to adjust their reward strategy in a manner that enhances the performance orientation. Sixty percent are considering making bonus plans more performance-based.

Another possible reason for the growing trend toward pay-for-performance is that organizations are simply getting better at implementing such plans. According to the annual Rewards of Work Study from Segal Sibson, 47% of employees believed their companies' performance management was effective in 2003, while 64% said the same in 2006.

But that doesn't mean that employers can't get considerably better in this area. A 2006 report from staffing firm Hudson suggests that workers do not yet believe pay is truly aligned with performance. More than a third of the workers in the *2006 Compensation and Benefits Report* indicated that they are not paid the same as people who do similar work, and 57% believe that tenure is the main factor in determining pay. Only 35% believe pay is determined by performance.

This continuing skepticism with PFP practice might well be due to the fact that a third of the respondents rarely or never have performance reviews. When they do receive raises, 50% feel it is simply a cost-of-living adjustment and not a reflection of their performance.

When planned and implemented well, however, such programs can be very effective. A study by Michael C. Sturman, Ph.D. and associate professor at the School of Hotel Administration at Cornell University projected that if a company

strongly tied all bonus opportunities to performance goals, there would be a significant increase in overall company performance (and presumably business results). His modeling suggested the gain may be as high as 16%.

One of the reward practices that continue to hamper the effectiveness of PFP plans for base salary increases is the misuse of the merit pay pool through inflated performance evaluations. Misguided attempts to keep up general morale by not seriously critiquing performance are negatively affecting top performers who - as a result of companies spreading available monies to a wider audience - receive little more in the way of pay raises than their less productive peers.

Hand in hand with that unfortunate practice is the tendency by many in management to believe that granting variable pay increases (as compared to general across-the-board adjustments) automatically means that their company provides pay-for-performance. So, while published reports clearly indicate a trend away from one-size-fits-all reward systems, one should look below the surface to learn whether employee performance is being appropriately measured and rewarded.

To effectively use a pay-for-performance system a company should 1) educate employees as to *what* performance will be rewarded. This requires measurements, and that performance objectives align vertically in the organization (employee goals relate to supervision, whose own goals relate to management, and on upward to corporate goals); 2) provide a well-defined rating scale that helps managers distinguish between levels of performance; and 3) provide a clear distinction of reward between those who have delivered and those who have not. An employee who does not see a relative gain from working hard all year is a lot less likely to repeat their performance the following year.

Making PFP work for your company will require hard decisions from line managers who are accustomed to maintaining employee morale by avoiding overt critical performance reviews. We have seen that, while there is a shift to rewarding individual effort, more monies are not being provided as a result of that shift. So in order to more effectively use available salary increase dollars companies need to reward their high performers with money effectively taken away from (not granted to) those performing at lower levels. This may also mean that average performers, the bulwark of so many companies, will receive less than they might otherwise expect. What it comes down to is a company’s ability to afford proper rewards for higher achieving employees (motivating and retaining them in the process) by reducing or eliminating rewards to those deemed as underperforming.

The risk exposure of course is that if managers, through utilization of performance management programs, do not properly identify and restrict awards for non-deserving employees, the PFP budget will not have enough funds to afford appropriate rewards for high performers. So you have to honestly ask,

who is it you would rather disappoint? Who has less impact on your business and whose loss will be less disruptive to your operations?

The decision to pay for performance should mean you have also decided not to pay if the employee hasn't performed.