Focusing Pay on Performance

As the competitive business environment increasingly pressures organizations to achieve ever-improving performance, companies have rushed to adopt some sort of pay-for-performance plan. **Pay for performance** devotes at least some portion of an individual's pay (ranging anywhere from 3 percent to multiples of 100 percent) to measurable performance outcomes.

> Building a Vocabulary of Change
> ***Pay for performance***
> pay that is tied to performance in the form of either a merit raise to base pay or an incentive bonus that does not increase base pay.

Pay for performance can take one of the two forms: *merit pay,* which raises base salary based on performance, and *incentive bonuses,* which offer regular but onetime payouts on the basis of performance. Bonuses do not alter base salary. They are considered onetime payments because they are not guaranteed. Substandard performance in the following year can reduce or eliminate the bonus.

Virtually every organization in the United States claims to have some kind of a merit pay system already in place. Incentive bonuses have become more popular over the past two decades. As a percentage of total payroll costs, bonuses rose from 4 percent in 1991 to 9 percent in 2000.[11]

Most organizations select a mix of performance pay in order to shape employee behavior. GE, for example, calls for a blend of different bonuses to motivate executives, as indicated in the following company statement:

- Salary and Bonus—We pay salaries that are designed to attract and retain superior leaders, and we pay annual bonuses to reward exceptional performance.
- Stock Options and Stock Appreciation Rights—We award these to provide incentives for superior long-term performance and to retain top executives because the awards are fortified if the executive leaves before they become fully exercisable five years after grant.
- Restricted Stock Units (RSUs)—We grant RSUs to more closely align executives' interests with investors' long-term interests, to retain top executives because the awards are paid out only to executives who remain with the company for extended periods.
- Long-Term Performance Awards—We use these to provide a strong incentive for achieving specific performance measurements over multiyear periods.[12]

Organizations seek a mix of rewards in order to help ensure alignment between employee behaviors and their strategic goals.

One question to be raised in introducing or redesigning a pay-for-performance plan relates to level of aggregation: at what level of outcome should a pay-for-performance incentive be targeted—the individual, the group or team, or the organization? Pay for *individual* performance dominates the design of compensation in the United States. **Exhibit 6-5** summarizes the various forms of individual pay-for-performance plans.

Theory into Practice

Individual incentives will be most effective in shaping behavior when the individual controls the outcomes being measured and rewarded, when the outcomes are tied to improved performance, when the evaluation of an employee's contribution is perceived as being valid, and when the difference between rewards for high and low performance is significant.

Piece rate	Employee earns all or part of a wage based on number of units produced
Commission	Salesperson earns all or part of a wage based on number of units sold
Merit pay	Employee earns raise to base wage based on performance evaluation
Bonus	Employee earns extra payment based on performance

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Exhibit 6-5 Forms of Individual Pay-for-Performance Plans.

Although individual pay-for-performance incentives seem to hold great potential for shaping behavior, a number of challenges constrict that potential impact. The first question that can be raised about a pay-for-performance plan relates to the degree to which individuals have *control* over the outcomes that are being measured and rewarded. Without a significant and clear relationship between individual effort and outcome, a pay-for-performance incentive can drain the system of its full behavioral impact.

A second question relates to whether the incentive system has targeted appropriate *measures of performance* on which to base the reward. Failure to include *all* outcomes that are important for outstanding performance can lead to dysfunctional consequences. The more effectively the system impacts behavior, in fact, the more likely it will be that singling out one aspect of performance for measurement will give that aspect disproportionate attention.

For an individual pay-for-performance plan to impact behavior, the pay increment tied to outstanding performance must be perceived as being *significant*. To have a behavioral impact, the additional reward for that behavior should be 10 percent to 20 percent higher than the reward received absent the behavior. Raises, however, often amount to a relatively small amount of total compensation, making their potential to impact behavior weak. The "significance range" can be reduced considerably—down to 3 percent to 5 percent—if raises are accompanied by public recognition and praise.[13] Concerns over secrecy and confidentiality, however, often blunt an organization's willingness and ability to accompany merit raises with public acknowledgment.

Finally, in order to be effective, pay for performance must be based on *valid judgments* about individual performance. Distortions often creep into the evaluation process, leading participants to question the validity of resulting assessments. That lack of trust in the evaluation process presents itself as one of the key reasons. U.S. employees report high levels of dissatisfaction with the implementation of their companies' pay-for-performance plans. Less than one-third of surveyed U.S. employees believe a direct link exists between pay and performance, despite company claims of a merit pay plan.[14]