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Pay for Performance

Six Takeaways to Shape a Better Outcome

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The concept of pay for performance is central to the compensation philosophy of most organizations. It is rooted in the belief that people should be rewarded based on their contributions. However, there is considerable debate about whether pay-for-performance systems increase employee engagement and performance.

Fortunately, academic researchers have done scores of excellent studies exploring the value of pay for performance. Unfortunately, very few compensation professionals read the journals where these studies are published.

This article is for compensation professionals who want to know what rigorous, peer review empirical research says about pay for performance, but who don't subscribe to the "Annual Review of Organizational Psychology," "Journal of Applied Psychology," "Organizational Behavior and Human Decision Processes" or similar academic periodicals.

The bulk of this article is drawn from two extensive reviews of compensation research by Gerhart and Fang (2015) and Shaw (2014). Both studies suggest that pay for performance can be highly effective, but only under certain conditions. The following are six takeaways from this research combined with my own thoughts and experiences gained from working in this field for 20-plus years.

> Pay for performance when it works seems capable of producing spectacularly good results. And when it does not work, it can likewise produce spectacularly bad results.
> – Professor Barry Gerhart, University of Wisconsin-Madison

TAKEAWAY NO. 1: Pay is not a reward, it is an investment.

A customer once told me, “We don’t pay people for their past performance. We pay people to influence their future performance. But the best predictor of future performance is past performance.” This is an important concept when thinking about pay for performance. Unless you are talking about highly transactional contract work, the purpose of pay for performance is not to reward people for what they have done. The purpose is to influence what people will do in the future. Pay for performance should be thought of as an investment to encourage people to do more of certain things and less of others. This includes influencing decisions about whether to leave the organization.

TAKEAWAY NO. 2: Pay has a massive impact on motivation, but not always in a good way.

Despite discussions about employee engagement and the value of purpose-driven work, reality dictates that pay is one of the most important factors influencing employee motivation. This does not mean pay is the only thing that affects motivation. It clearly is not. But pay has tremendous potential to hurt employee commitment and engagement. Don’t believe me? Try not paying your employees next month.

It is very easy to demotivate people through inequitable pay strategies. People do not like it when others get paid more money for doing the same job, particularly if they are both performing at the same level. Companies can avoid most of the demotivating aspects of compensation by monitoring internal and external pay equity and ensuring employees are not grossly underpaid or overpaid relative to their peers doing similar work. In sum, if you pay for performance, make sure you do it fairly and consistently across your employee population. And make sure employees know the company is taking care to ensure they are paid fairly.

TAKEAWAY NO. 3: Pay for performance is more about 'how' vs. 'how much.'

It is common to hear people say things such as "Why should we implement pay for performance if we only give out 2% merit increases?" The answer is simple: The effectiveness of pay for performance depends far more on how pay differences are allocated and communicated than on the actual differences in the amount of pay given.

For example, if an employee knows he or she received a 2% merit increase when most peers received 1.5% and that this difference is based on the relative strength of employee contributions, then that 0.5% difference is likely to have a significant impact on that employee's motivation. The key is, employees must be told that they are receiving a higher level of rewards than their peers and be told what they did to earn it.

TAKEAWAY NO. 4: Pay for performance requires balancing paying too little vs. paying too much.

Psychologists who study compensation use the term "pay dispersion" to describe differences in compensation across employees working in the same job or organization. Having too much pay dispersion can demotivate employees. Pay dispersion tends to show a curvilinear relationship to employee motivation.

Zero-pay dispersion, which means paying everyone the same, also tends to be demotivating. It is particularly demotivating for high-performing employees. It is frustrating when people who do not show commitment to doing a good job are rewarded equally as their harder working peers. As pay dispersion increases, motivation tends to increase, assuming pay differences are allocated based on performance. But this starts to reverse at some point. If pay dispersion becomes too great, it creates feelings of anxiety that hurt performance. It also can create unhealthy competition that undermines people's sense of teamwork and collective commitment.

In sum, paying high performers more than low performers is motivating, but not if the differences become too large. The challenge is figuring out where this tipping point is for a particular job or organization.

TAKEAWAY NO. 5: Paying for performance does not necessarily decrease intrinsic motivation for work.

A common belief about psychology is that “extrinsic motivators” such as pay decreases people’s sense of “intrinsic motivation” toward a job or a task. The argument is that if you pay people to do a task that they had been doing voluntarily, then that task becomes less interesting and enjoyable. This can be true in certain settings such as asking people to solve puzzles for a few hours or perform simple, piece-rate types of work. But this trade-off between intrinsic and extrinsic motivation does not generalize to most professional work settings. In these settings, pay is not used to reward single isolated acts or accomplishments, but to demonstrate appreciation for contributions resulting from months or years of work.

This does not mean that intrinsic motivation is unimportant. The inherent interest and value people find in their work has a major impact on their commitment and performance. But the idea that intrinsic and extrinsic motivation are somehow mutually exclusive is wrong. The most motivated employees find their work intrinsically rewarding and believe they are receiving appropriate extrinsic financial rewards for their contributions.

TAKEAWAY NO. 6: Pay for performance works if it gives people a sense of appreciation and empowerment.

People expect to be paid for their work. And the more value people contribute to the company through their work, the more they expect to be rewarded in return. The challenge is creating a pay-for-performance process that

makes employees feel appreciated for past contributions and empowered to influence future pay decisions. To do this, pay-for-performance methods must meet the following criteria.

Transparency. This involves providing employees with a clear explanation of the details about how the company makes pay decisions. This includes who makes these decisions, when the decisions are made, the data used to guide the decisions, and the checks and balances that are in place to ensure the decisions are fair and accurate.

Influence. Pay for performance is based on the theory that people perform more effectively when it leads to greater financial rewards. This only works if people understand the job objectives they are expected to achieve, believe they can achieve them, and are confident that achieving them will influence future pay decisions. The entire concept of pay for performance hinges on employees believing they can influence future compensation by accomplishing job goals. This will not happen unless employees have well-defined and achievable job expectations. This is not the case in many organizations.

Recognition. A company may pay employees based on performance, but the company will not see the benefits of pay for performance unless employees understand the link between their personal contributions and their compensation. This requires taking time to explain to employees the connection between their compensation and their performance contributions. It also may involve explaining what compensation employees would have received had they performed differently. It is unlikely and unwise to expect managers to have this sort of conversation with their direct reports unless they are trained on how to do it effectively.

Equity. One of the foundations of pay equity is “equal pay for equal contributions.” Pay-for-performance processes should include clear guidelines and methods to ensure pay decisions are based on actual employee performance. Pay should depend on what employees contribute. It should not be based on an employee’s skill negotiating for a raise, or how lenient or strict a manager is toward holding people accountable for performance.

Pay for performance is a core element for creating high-performance organizations. But it can hurt productivity if it is poorly implemented. Companies spend billions of dollars every year on pay-for-performance strategies, but often do not know if they are spending this money wisely. If you want to gauge the effectiveness of your pay-for-performance methods, have your employees ask themselves the following questions:

1. Do I understand how the company makes pay decisions that affect me?
2. Do I feel past pay decisions adequately recognized the contributions I made to the company?
3. Do I believe I can meaningfully influence future pay decisions that affect my life and career?

Of these three, the third is probably the most important. We don’t pay people merely to recognize the things they have done in the past. We pay people with the hope it will influence their future actions and contributions.

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