Making pay for performance work

An excerpt from the book *Common Sense Talent Management.*

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Pay-for-performance is a philosophy that employees should receive different amounts of compensation based on their level of job performance. It is rooted in a belief the people will be more productive if they are paid for their results. Pay for performance is generally a good idea, but it may not work as intended unless companies think through several important concepts.

Implementing a pay-for-performance compensation structure does not directly lead to improved business results[1]. What it does is provide managers with tools to reward employees who achieve goals that support the company's strategy. This is done with the assumption that employees will be motivated by the promise of future pay to achieve these goals. But this assumption may not be true. Pay for performance will only work if employees:

- understand their goals,
- see the pay rewards as adequate incentive for pursuing these goals,
- feel they are capable of achieving the goals, and
- use methods employees to achieve the goals that align with the needs of the business.

If these conditions are not met then pay for performance programs may actually decrease workforce productivity by de-motivating employees or encouraging counterproductive behaviors (for an example see the story below, "Why paying employees to be safe can be unhealthy"). A well designed pay for performance process must take these factors into account to ensure it works as intended.

Adopting a pay for performance mindset, while generally a good idea, can also over-simplify what business leaders truly want and what actually motivates employees. To illustrate this, consider the following four pay for performance cultures in order of best to worst to somewhere in-between.

The best scenario: Performance without pay. Business leaders don't actually want to pay for performance. What they ideally want is performance without having to pay. But most employees are not willing to accept this proposition. We rightfully expect to be paid for what we contribute. Nevertheless, it is possible to inspire people to achieve high levels of performance without focusing on pay. Volunteer organizations do this all the time. There are a lot of things that motivate people. The motivational value of pay varies depending on the type of job and employee, and business leaders who use pay as the sole tool for motivating employees risk adopting a very expensive and marginally effective leadership approach.

The worst scenario: Pay for poor performance. The worst case scenario for a business occurs when employees are rewarded for doing things that undermine company performance. This occurs more often than companies would like to admit, particularly in companies whose managers have to comply with restrictive personnel policies, rules, and regulations. Rewarding poor performance encourages counterproductive behavior and destroys the motivation of high performers. High performers dislike it when they do not receive any sense of recognition or rewards for their contributions. But they hate it when they see rewards going to poorer performing colleagues.

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[1] Schaubroeck, J., Shaw, J. D., Duffy, M. K., & Mitra, A. (2008). And under-met and over-met expectations model of employee reactions to merit raises. *Journal of Applied Psychology, 93(2),* 424-434.

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A lousy scenario: Performance only for pay. One of the problems with creating a direct link between pay and performance is some people will never feel they are getting paid enough. No matter how much pay these people receive for doing something, over time they always seem to want more. Payouts can quickly switch from being a reward to being an expectation. Today's financial bonus is tomorrow's entitlement. Once this happens, pay ceases to be a motivator and becomes a source of dissatisfaction.

The pragmatic scenario: Performance influences but does not completely determine pay. Research on productivity, fairness, and motivation indicates that there should be a positive relationship between how much people are paid and how much they contribute to the company. But the relationship between pay and performance does not need to be perfect to be effective. Many things influence pay levels beyond individual performance (e.g., overall company financials). Conversely, pay is only one of many things that influence performance. Company's should create a link between performance and pay, but should not overemphasize pay as the only reason why employees should seek to perform at higher levels.

Establishing links between pay and performance does tend to increase productivity. But it is not just the promise of pay that drives the productivity. When you link pay to performance, employees and managers get much more serious around defining what they mean by "performance". And clearly defining performance expectations drives all kinds of benefits for increasing workforce productivity, regardless of pay levels.

This raises what may be the most challenging and important aspect of pay for performance. Pay for performance assumes your company has some way to accurately measure the value of someone's performance. Does your company accurately define and measure employee performance and reliability and fairly differentiate high from low performing employees? If the answers to this question is "no" or "not very well" then you have to wonder about your company's ability to truly implement pay for performance.

Why paying employees to be safe can be unhealthy

Pay for performance programs motivate employees by providing financial rewards based on achievement of specific goals or outcomes. If used correctly, pay for performance methods have been shown to significantly increase employee productivity[2]. However, pay for performance plans can create significant problems for organizations if they are not carefully thought through. One example comes from efforts to use pay for performance to reduce workplace accidents and injuries.

To encourage safe behavior, some manufacturing plants have given employees bonuses if there were no accidents or injuries during a certain period of time. For example, paying a bonus to employees for every week that passed without any accidents. When companies used this approach what they discovered was accident rates did not necessarily go down, but what did decrease was employees' willingness to report accidents. Rather than reporting accidents employees would hide them so they could achieve their bonuses. Plant managers have told me about employees continuing to work with severe injuries such as a broken leg because they did not want to file an accident report. The employees did not feel they could effectively control accident rates, so they found another way to achieve the rewards.

The lesson to be learned is you often get what you pay for, but what you pay for may not actually be what you want.

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[2] Peterson, S.J. & Luthan, F. (2006). The impact of financial and nonfinancial incentives on business-unit outcomes over time. Journal of Applied Psychology, 91, 156-165.

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