

Avoiding the Performance Pay Employee Entitlement Trap

By Kimberly Merriman, Ph.D.

QUICK LOOK

- ⇒ While employees develop an entitlement mentality for many different reasons, the consequences of pay entitlement are consistent regardless of the underlying cause.
- ⇒ Consequences of entitlement extend beyond monetary rewards.
- ⇒ It's human nature to overestimate our own performance, while at the same time underestimating the contribution of others, leading to unrealistic employee expectations under individual incentive plans.

Performance pay is increasingly used throughout all levels of the organization as a tool to motivate employees, reduce fixed costs and gain pay flexibility. However, employees often develop feelings of entitlement toward performance pay that are counterproductive to this purpose. The perception of performance pay, like beauty, is in the eye of the beholder. What the organization labels an incentive, employees may view as their entitlement. Employers must understand and manage these perceptions in order to

maximize the effectiveness of performance pay plans. This article examines the three primary problems associated with pay entitlement and details methods for managing employee pay expectations in order to enhance organizational results.

Consequences of Pay Entitlement

Pay entitlement diminishes the return that employers realize from performance pay — performance pay dollars can be wasted or, even worse, provide a negative

entitlement

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return. While employees develop an entitlement mentality for many different reasons, the consequences of pay entitlement are consistent regardless of the underlying cause. Once pay entitlement sets in, organizations are faced with the following three problems:

- **Decreased motivation when entitlements are not received.** Entitlement makes employees unwilling to accept a reduction or deletion of performance incentives, despite the intended uncertain and varying nature of performance pay. For instance, DuPont saw employee morale decline sharply when it became apparent that incentive targets, and thus incentive payouts, which employees had grown to expect, would not be met. Consequences of entitlement extend beyond monetary rewards. When Claremont Resort and Spa decided to cancel the annual holiday turkey for employees, workers showed their resentment by presenting the hotel with a "golden turkey" award. The company returned to giving out turkeys the following year.
- **Reluctance to accept even potentially positive changes.** Established economic theory indicates that changes to entitlements are viewed as having something taken away, and losses are psychologically more painful than foregone gains. In other words, the chance of losing \$50 worries us more than the possibility of gaining \$50 gratifies us. This quirk of human nature limits management's flexibility in implementing and administering performance pay. A study of bank employees showed lower pay satisfaction, despite higher earnings, when employees had part of their fixed pay replaced with performance-based pay. In a classic study of piece rates, employees also strongly resisted any change to the status quo. When pay programs are changed, an entitled employee will focus on the pay threat rather than the potential gain.
- **Excessive risk taking to meet performance targets.** Research also shows that individuals will take on more risk to avoid a potential loss than they will to secure an equivalent gain, possibly to the detriment of the organization. Although organizations flourish from a certain amount of

employee risk taking, too much threatens product or service quality and may lead to the crossing of legal boundaries. There are many notable instances where top management pursued questionable investments in order to reach or maintain performance targets. Likewise, employees under gainsharing programs stretch for new ways to increase production efficiencies as the more legitimate methods are exhausted.

Managing Employee Expectations

Organizations can minimize pay entitlement by taking steps to proactively shape employee expectations. Employee pay expectations tend to rise faster than they fall. Individuals adjust expectations upward as rewards rise, but are not as quick to ratchet their sights back down when performance and related rewards decline. Individuals then adapt their spending levels — spend, take on debt and even deplete savings — based on these upwardly biased pay expectations. Studies show that psychologically distinguishing variable pay from fixed pay can reduce expectation inflation and adaptation of spending levels. There are five easy ways to do this.

- **Separate the payment of performance pay from fixed pay.** Amounts included in the regular paycheck are viewed as recurring. Stand-alone payment of performance pay helps reinforce its variable and contingent status.
- **Use the proper description.** Refer to performance pay as "special" in order to convey the right message. Do not use labels such as annual bonus or quarterly incentive, which may suggest permanence and encourage entitlement.
- **Clearly communicate the contingent nature of performance pay up front.** Discuss the possibility of a reduced or zero payout. Do not stress only the positive, while strategically withholding the potential downside, in an attempt to make the plan more motivating.
- **Make clear exactly what performance is relevant.** Under gain-sharing or profit-sharing plans, employees who do their individual jobs well may feel entitled to receive performance pay regardless of group or company performance.

“psychological contract”

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that employees hold, they may feel deserving of a payout for reasons beyond the specific performance in question (e.g., because of their commitment to the company or willingness to accept low fixed pay).

- **Provide ongoing and realistic performance feedback.**

Management has a tendency to shield employees from bad news regarding corporate performance, leading to inflated employee expectations under profit-sharing plans. It's human nature to overestimate our own performance, while at the same time underestimating the contribution of others, leading to unrealistic employee expectations under individual incentive plans. Accurate performance feedback helps employees adjust and maintain realistic expectations.

When Pay Entitlement is Unavoidable

Not all pay entitlement can be avoided. Some personalities are predisposed to entitlement. Certain employment relationships are more inclined toward entitlement. Depending on the “psychological contract” that employees hold, they may feel deserving of a payout on performance pay for reasons beyond the specific performance in question (e.g., because of their commitment to the company or willingness to accept low fixed pay). Microsoft clearly experienced this in 2003, deciding to make good on employees' worthless stock options in order to retain motivated workers.


There also are common variants of performance pay that may facilitate feelings of pay entitlement. If earnings are at risk, meaning the fixed component of pay is below market level and the variable component comprises the remainder, a feeling of potential pay loss will be more salient. When pay is based on individual performance — particularly individual behaviors as opposed to more objective outcomes — self-serving biases are more apt to leave employees with an inflated opinion of their performance and higher pay expectations.

In situations of unavoidable pay entitlement, management can improve employee acceptance by focusing on the following:

- **Minimize employee feelings of loss.** To offset feelings of loss, employers can offer intangible benefits when dollar payouts are diminished. Career growth, ultimately leading to compensation growth, may be particularly effective with employees who are focused on monetary returns.

- **Maximize employee fairness perceptions.** Increasing employee perceptions of fair process is critical when dollar payouts are diminished or performance pay plans are altered in any way. If the process is considered fair, the outcome or change will be more readily accepted. There are many instances where employees contentedly forgo bonuses, or even take pay cuts, in the spirit of unity for a financially strapped company. However, when the process is viewed as unfair, virtually any change or outcome is disagreeable. For instance, in the airline industry the same employees that agreed to forgo pay to show support for the company quickly mutinied when they found out top management was still reaping generous rewards.

Now Take Action

Pay entitlement can turn performance pay plans into demotivation plans. Organizations can avoid the entitlement trap and maximize the effectiveness of performance pay dollars by following the techniques in this article. These techniques encourage employers to address the psychological aspect of performance pay. Primarily, employers must understand and manage employee expectations in order to avoid the **entitlement trap**. 

ABOUT THE AUTHOR

Kimberly K. Merriman, Ph.D., is a business writer, educator and consultant specializing in rewards issues and a WorldatWork member since 2004. She can be reached at kkmconsult@hotmail.com or 316/304-8952.

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