Rewarding bad management:
Risks of making compensation decisions with performance evaluations

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My job involves helping companies around the world determine how to use HCM technology to increase workforce productivity. This work has taught me there is no one "best practice" for things like performance management, employee development, or recruiting. Methods that work well in one company may fail in another. But every so often I encounter a method that strikes me as a universal "worst practice". These practices are not just sub-optimal, they actually lead to counterproductive employee behavior. One worst practice I've recently encountered is allowing managers to make compensation decisions without assessing whether the decisions reflect the level of contribution employees are actually making to the company. In other words, allowing managers to make pay decisions based solely on personal opinion without any method to ensure the decisions are also in the best interest of the larger organization.

Best practice: investing in employee value. Most companies require that managers provide justification for paying some employees on their teams more than others (this excludes employees whose pay is set based on collective bargaining or some other regulatory method). If a manager gives one employee a 5% increase and another a 1% increase they must show that this decision follows guidelines to ensure employees are compensated based on the contributions they are making to the company. This practice is usually referred to as "pay for performance". But that can be too narrow a definition since many companies encourage managers to look at more than just past performance when making pay decisions including things such as future potential, technical capabilities, market value of skills, or other criteria that indicates the value an employee provides to the company. Creating a clear link between pay decisions and employee value increases workforce productivity by ensuring the company invests more resources in employees who will provide the greatest return on this investment. It also increases employee engagement because employees understand how compensation decisions are made. Employees are more likely to accept pay decisions as fair since they are based on what the employee actually contributes to the company.

There are many ways to create links between employee contributions and compensation. The simplest method is to have managers rate employee performance and then make pay decisions so they fall within ranges based on different performance levels. Many companies find it more effective to eliminate manager ratings of performance and instead evaluate employees using calibration meetings or by tracking performance against specific goals and then make pay decisions based on these evaluations. Whatever method is used, the key point is manager's must show a relationship between how they choose to pay employees and the contributions those employees make to the organization.

Worst practice: paying without explanation or justification. Years of research have shown the value of paying for performance <insert cite>. Yet I've recently encountered several companies that are considering removing formal ties between manager pay decisions and employee contributions. These companies would simply give managers a pool of money and let the manager decide how to allocate the money across their direct reports. Managers will not be asked to make any rating of performance, nor will they be required to explain how they make pay decisions. The company will not have any way to measure whether manager pay decisions reflect actual employee contributions because they won't have any measure of employee contributions. The supposed benefit of this approach is it avoids tension

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caused by rating employees based on the value they provide to the organization. But this approach will almost certainly create far larger problems than any that might be avoided by "eliminating ratings".

- **Enabling managers to make extremely poor pay decisions.** One reason people advocate getting rid of ratings is because some managers struggle to accurately evaluate performance. If managers do not know how to evaluate performance, then they probably don't know how to make fair and equitable performance based pay decisions either. Allowing managers to make compensation decisions without justifying how they made these decisions could easily result in terrible allocation of pay. Furthermore, the company will never know how bad these decisions are because they have no way to assess if manager pay decisions reflect job relevant performance criteria.

- **Enabling weak managers to avoiding difficult conversations.** One thing managers think about when making a pay decisions is how employees will react when they tell them what increase they are (or are not) receiving. Difficult discussions can result when employees learn they are not getting what they feel they are entitled to receive. Strong managers accept these conversations as a necessary but challenging part of being a good leader. Weak managers try to avoid these conversations if at all possible.

  If managers do not have to justify pay decisions based on performance measures they are likely to sacrifice making the right long-term decisions and instead take the short-term "path of least resistance". Consider the following scenario. A manager has two employees, Bill and Sue. Sue is a high performer who achieves all her goals and often exceeds expectations. She also keeps her calm and does not overly complain when things don't go her way. Bill is a solid employee with valuable technical skills, but in recent years he has grown complacent. His work is okay but far from great. He's also become difficult to get along with particularly when things don't go his way. The manager knows Sue deserves a much higher raise than Bill. The manager also knows that Bill is going to raise all kinds of trouble if he doesn't get the raise he believes he should receive, even if he doesn't actually deserve it. In contrast, the manager knows Sue won't complain if she doesn't get all she hoped for. Her willingness to look past disappointment is one of the reasons she is such a high performer. Will this manager make the right long-term decision and give Sue more than Bill, even though it means having a tense conversation with Bill about his mediocre performance and negative attitude? Or does the manager make the easy short-term decision to pay Bill and Sue the same amount just to keep things calm? If the manager knows they won't have to explain their pay decision to anyone other than Bill and Sue, then just paying everyone the same is going to be the easier way to go. At least until Sue eventually quits out of frustration over not being recognized for her contributions and having to constantly tolerate Bill's poor behavior.

  The reality is many managers will avoid having difficult conversations with their employees as much as they possibly can. If these managers don't have to explain their pay decisions, then they will make pay decisions that make their lives easier in the short-term even if it leads to bad long-term outcomes. Weak managers in particular will like that they no longer have to deal with the difficult reality that all employees are valuable but some employees are more valuable than others.

- **Frustrating high performers.** Most high performers are motivated by being recognized and rewarded for their contributions. Removing the formal connection between performance and compensation decisions is likely to demotivate these people. Even high performers who do not desire a lot of personal recognition will still be frustrated when they discover their lower performing colleagues may be getting pay raises equal or higher to the ones they receive. In contrast, many low performing employees will prefer a compensation process the does not strongly link pay to

performance. The result is a process that decreases engagement and retention of high performers while increasing engagement and retention of lower performers. This is not a good formula for increasing overall workforce productivity.

- **Creating an environment primed for biased pay decisions.** Research has shown that women tend to be paid less than men for two reasons. First, people often have an implicit bias to pay women less than men (this bias exists in both men and women) <cite>. Second, women tend to be less willing to argue for higher pay compared to men <cite>. The best way to avoid a pay bias against women is to ensure pay decisions are based on clearly defined performance criteria. Allowing managers to make pay decisions without requiring them to justify their decisions, or without evaluating pay decisions to ensure they are based on valid criteria is a great way to generate biases in compensation based on non-work relevant employee characteristic such as age, race, or gender.

It feels odd to find myself writing a blog in defense of basing pay decisions on well-defined performance criteria. Linking pay to employee contributions is a fundamental and common sense part of a high performance work environment. But some people currently seem to think paying people for performance is not worth the anxiety and effort that can be associated with measuring employee performance. It is like they are going from “pay for performance” to “pray for performance”. In my professional opinion, this is the embodiment of a worst practice. It is taking the easiest route in the short term without fully thinking through the long-term negative consequences. There are effective ways to eliminate or downplay the role of manager ratings in performance management, but this most definitely is not one of them <TLNT cite>.

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