Making compensation decisions without any link to performance ratings: Does it make sense?

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My job involves helping companies use technology to increase workforce productivity. This has taught me there is no one "best practice" when it comes to human capital management. Methods that work in one company may fail in another. But every so often I encounter a practice that may actually encourage counterproductive behavior. One such trend is the move toward making compensation decisions without any link to performance ratings.

Effective practice: conducting performance ratings separate from compensation decisions

Many companies are moving performance ratings out of the annual compensation review process. This often makes sense, particularly when the performance rating process has become so tightly coupled to compensation that it is basically a compensation justification exercise. This often occurs when processes dictate specific compensation increases based on performance ratings. For example, if an employee is rated as a "solid performer" then they automatically get a 3% increase but if they are rated as "outstanding contributor" they get a 4% increase. A quick way to test if your performance assessments are too tightly tied to compensation is to ask "if there was a pay freeze would there be any reason to conduct performance ratings?" If the answer is "not really" then managers probably aren't focusing on measuring performance in the ratings anyway but are just looking for a way to validate pre-existing compensation decisions. In such situations you should look for ways to differentiate rating performance from making compensation decisions.

Dangerous practices: totally eliminating performance ratings

There are many reasons why it is important to have consistent, well-defined methods to measure employee performance in and of itself. This includes things like tracking turnover of high vs. low performers, or correlating pay decisions with performance ratings to ensure managers are investing more in those employees who contribute more to the company. Allowing managers to make compensation decisions without using some form of performance rating to guide these decisions can create a host of other problems including:

- **Confusing pay variance for accuracy.** Some companies that eliminated performance ratings have noted that there is still a lot of variance in how managers allocate pay. They use this as justification that the process is working since managers are not paying everyone the same. The risk is these companies do not know why the managers have chosen to pay some people more than others. Paying people different amounts is not the same as paying people fairly.

- **Allowing poor pay decisions.** One reason people advocate getting rid of ratings is because managers may struggle to accurately evaluate performance. If a manager does not know how to evaluate performance, then they probably don't know how to make equitable performance based pay decisions either. Allowing managers to make compensation decisions without any performance data to validate these decisions can lead to ineffective and unfair allocation of pay. But the company will never know how bad these decisions are because they have no way to effectively compare manager pay decisions to job relevant performance criteria.

- **Increasing bias against women.** Research suggests that compensation decisions made without performance ratings are likely to be more biased than processes that link compensation increases to performance metrics. A recent study looking at gender bias in pay and performance decisions found that "the mean sex difference in rewards was 14 times larger than the mean sex difference in performance evaluations." (Joshi et al., 2015). One way to reduce unfair and potentially illegal biases in pay decisions is to ensure they are based on clearly defined performance criteria. This may be hard to do across large populations of employees without using some form of performance ratings.

- **Implicitly pressuring managers to make compensation decisions based on gender.** Companies often monitor whether pay decisions systematically favor one gender over another. But gender based pay differences by themselves do not necessarily imply biased pay decisions. From a statistical standpoint, by chance alone one will occasionally encounter teams where women tend to perform at lower levels than men or where men tend to perform at lower levels than women. If managers of these teams feel pressured to ensure compensation decisions are equal they may change pay solely to decrease perceptions of gender bias even if the differences are justifiable based on performance differences. People may start assuming that "pay decisions depend in part on employee gender". Such beliefs generate even greater issues related to gender equality.

- **Enabling weak managers.** One thing managers think about when making a pay decisions is how employees will react to the increase. Difficult conversations can result when employees discover they are not getting what they feel they are entitled to receive. Strong managers accept these conversations as a necessary part of being a good leader. They are prepared to deal with the reality that all employees are valuable but some employees are more valuable than others. Weak managers try to avoid these conversations whenever possible.

  If weak managers don't have to explain their pay decisions, then they are prone to pay decisions that make their lives easier in the short-term but that lead to bad long-term outcomes. Consider the following scenario. A manager has two employees, Bill and Sue. Sue is a high performer who often exceeds expectations. She also keeps her calm when things don't go her way. Bill is a solid employee with valuable skills, but in recent years he has grown complacent. His work is okay but far from great. He's also difficult to get along with when things don't go his way. The manager knows Sue deserves a higher raise than Bill. The manager also knows Bill is going complain loudly if he doesn't get the big raise he believes he should receive. In contrast, the manager knows Sue won't complain if she doesn't get all she hoped for. Will this manager make the right long-term decision and give Sue more than Bill, even though it means dealing with Bill's negative attitude? Or does the manager decide to pay Bill and Sue the same amount just to keep things calm? If the manager knows they won't have to justify their pay decisions then underpaying Sue and overpaying Bill is going to be the easiest way to go. Until Sue eventually quits out of frustration over not being recognized for her contributions and having to tolerate Bill's poor behavior.

- **Frustrating high performers while pleasing low performers.** Most high performers want to be rewarded for their contributions. Eliminating a formal connection between performance and compensation is likely to demotivate these people. High performers will also be frustrated if they discover their lower performing colleagues are getting pay raises equal or higher to the ones they receive. In contrast, low performing employees may prefer a compensation process the does not 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.

- **Confusing simple with effective.** Some companies have found that certain managers and employees initially find it easier to use compensation processes that have no link to performance ratings. But we do not know how these employees may feel about the process when they encounter pay decisions they do not agree with. And conducting compensation without any link to performance rating could quickly lead to highly inequitable pay decisions.

Linking pay to employee contributions is a fundamental and common sense part of a high performance work environment. Yet some people seem to think it is not worth the effort required to actually measure employee performance. Many companies I work with are our finding it beneficial to remove performance ratings from the annual review process, but they are not getting rid of ratings completely. They are just rating in a different manner. Totally abolishing performance ratings is an extremely risky and I would argue futile endeavor. The question is not whether employees are rated, but whether they are being rated in fair, accurate and transparent manner that effectively influences the tangible decisions that impact people's careers such as pay. A great many companies have shown that is is possible to create performance rating processes that can be very effective for ensuring pay decisions are fair and equitable. But no one ever seems to talk about companies that like their performance rating methods. Sadly, it seems like a popular fad in HR right now is to say performance ratings are inherently bad – even if they aren't.