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Blending General Increases With a Pay-for-Performance Policy

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Perspective
On Compensation Design . . .

Blending General Increases With a Pay-for-Performance Policy

BY DOW SCOTT

The system of awarding annual across-the-board merit raises—central to how most employees are paid—no longer makes sense.

In a society with an abiding belief in a meritocracy, how can one argue that distributing general pay increases evenly to all employees is preferable to awarding the largest pay increases to the best performers? Merit pay in general has proven to have marginal motivational value and contributes little to the retention of talented employees.

What’s Wrong With Merit Pay?

Merit pay budgets have been too small to make much of a difference. For more than a decade, merit increases have averaged 2 to 4 percent, with some companies suspending them during the recent economic downturn. As a result, employees often consider the increase they receive insulting.

Also, managers who rate employee performance and distribute merit increases are extremely reluctant to distinguish between high performers and good performers. This is not surprising, since managers rely on both high performers and good performers to get the job done. Data indicate that tenure is the typical driver of pay increases in most organizations, leaving many older employees overpaid for their contribution.

Folding merit increases into base pay every year also permanently ratchets up pay levels, to which corresponding increases in company performance may not keep pace.

In addition, pay ranges today are so wide that modest merit increases and annual adjustments make it almost impossible for employees to progress from the bottom of the range to the top, no matter how well they perform. It becomes understood that to get a substantial pay increase one needs to be promoted or take a job with another organization.

Another Way

While the solution for these many problems is to eliminate merit pay as a program, I am not suggesting that companies quit rewarding performance or adjusting pay levels as necessary.

Base pay adjustments should relate to market, not merit.

Adjustments in base pay can still occur, but only to account for changes in the price the marketplace pays for a particular position—not for increases in the cost-of-living or individual performance.
To keep the organization's pay strategy on track, pay surveys for positions in relevant labor markets should be conducted every year or two and pay levels adjusted accordingly.

Adjusting base pay in response to labor market changes sends the message to employees and their managers that their wages or salaries are pay for the responsibilities and capabilities required to do the job.

Pay ranges may be maintained, but not as a tool for positioning pay levels based on employee performance. Instead they can be used for slotting employees whose competencies or experience indicates they are capable of performing the job at higher levels than other employees in the same position.

These adjustments may resolve the merit pay quandary, but how does one now reward employee performance?

Factoring In Performance

There are many programs that can be used to reward individual, team or organizational performance, including: short-term incentives, long-term incentives, equity awards in the form of restricted stock or stock options, bonuses for a wide variety of performance criteria, and other reward and recognition programs.

The benefit of using incentives to reward performance is that incentives do not roll the rewards for performance into base pay. Thus, under this system, base wages do not increase unless the labor market demands it.

Further, incentive programs allow managers to clearly specify that this money is for performance and to articulate how the performance is measured.

Finally, since incentives are typically paid annually or quarterly, the amount of money the employee receives in a lump sum is much more substantial than seeing a percentage increase divided by 24, 26, or 52 pay periods.

The next question is: “How do you get out of a merit pay program after years of saying it is the right thing to do?”

A good place to start is to recommit your company to rewarding performance. Convince managers and employees that merit pay is not a very good way to reward performance.

Replace merit pay programs with short- and long-term incentives that have clear performance goals that drive business success and make sense with performance criteria, which employees can influence.

With good communication, combined with employee and manager involvement, firms could be surprised at how little push back from employees a move away from merit pay generates.