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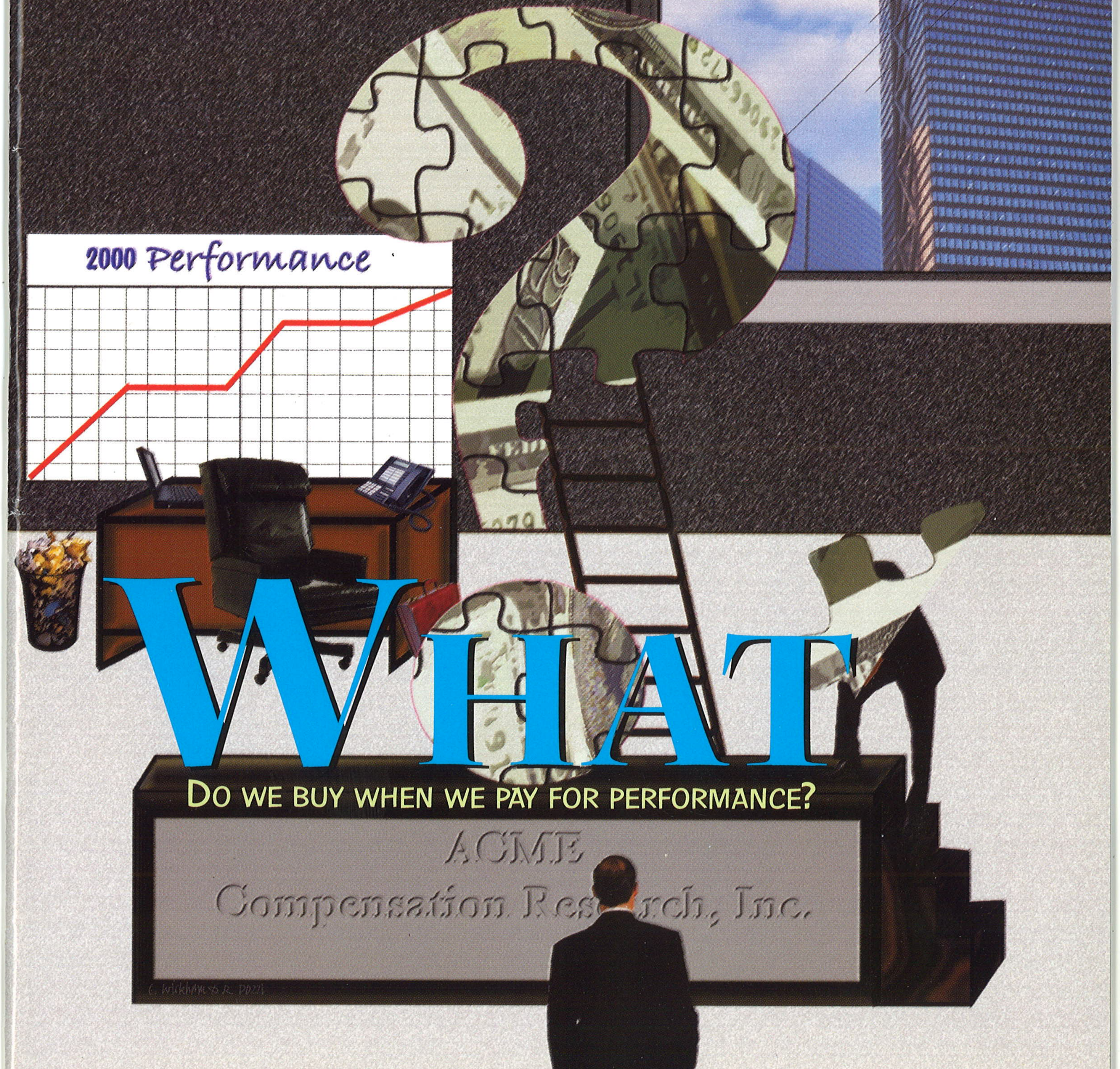

WHAT DO WE BUY WHEN WE PAY FOR PERFORMANCE?

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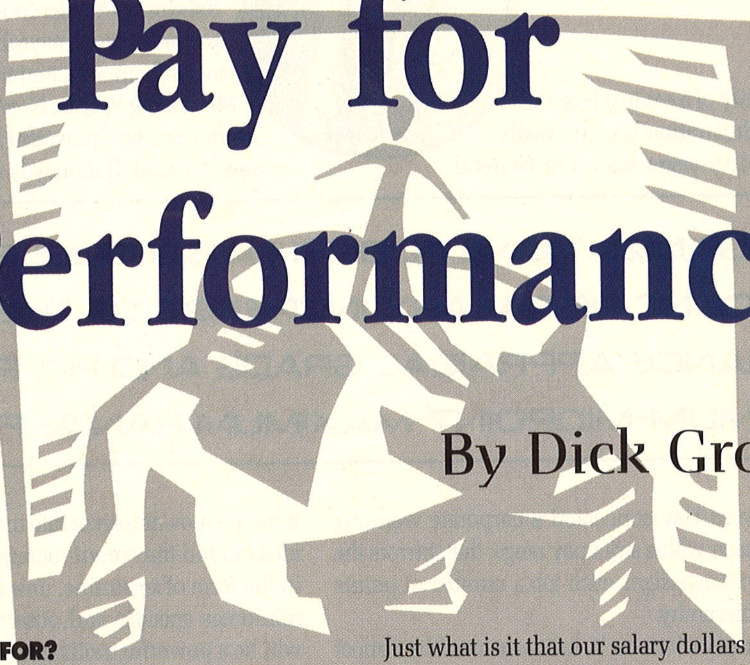


By Dick Grote

WHAT DOES PAY PAY FOR?

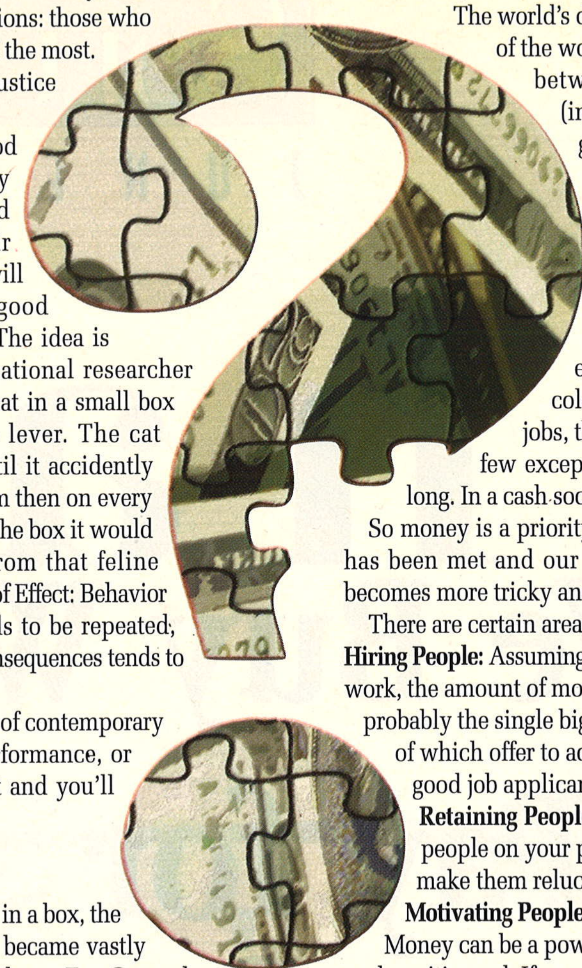
What are we purchasing with the money we put out in pay? With any other corporate expenditure it is relatively easy to answer the question, "What did we get for the money we spent?" But once we move much away from the purchase of direct labor at an hourly rate, or a sales commission based on number of widgets sold, or a Frederick Taylor scientific-management piece-rate scheme, we struggle to make tangible the quid-pro-quo of compensation.

Just what is it that our salary dollars buy? And how do we manage compensation systems so that we get the most from our money?

TRADING EFFORTS FOR DOLLARS

The relationship between employer and employee can be viewed in its most simple form as an exchange relationship: Employees trade their time and talent for organizational rewards.

Most organizations primarily subscribe to the reward equity norm. According to the this theory, rewards should be allocated in proportion to contributions: those who contribute the most should get paid the most. Basic principles of fairness and justice drive the equity norm.



If an organization identifies good performance and subsequently awards bigger paychecks to the good performers rather than to their weaker brethren, the organization will increase the amount of good performance, so the theory goes. The idea is certainly not new. In 1913, educational researcher Edward L. Thorndike dropped a cat in a small box with a secret door-opening trip lever. The cat behaved wildly and randomly until it accidently tripped the lever and escaped. From then on every time Thorndike put the cat back in the box it would instantly return to the lever. From that feline observation came Thorndike's Law of Effect: Behavior with favorable consequences tends to be repeated, while behavior with unfavorable consequences tends to disappear.

Thus developed the key concept of contemporary salary administration: pay for performance, or merit pay. Reward what you want and you'll get more of it.

SIMPLICITY ITSELF

From the original simplicity of a cat in a box, the technique of salary administration became vastly more complex about thirty years later. For General Foods in the 1940s, Edward Hay concocted a corporate wedding cake of 20 to 40 job tiers, each with a strict pay range, that mirrors the hierarchy exactly. The system assigns each job a number of points based on its level in the hierarchy.

The Hay system, or some variant on it, has been used by almost every large organization for the past fifty years to administer salaries. But *Fortune* writer Jaclyn Fierman observes that companies are eagerly seeking to replace the clunky Hay system because it accentuates the turf-consciousness that most companies are trying to eradicate. The essential problem? Employees are urged by bosses "to be creative, entrepreneurial, boundryless team players, but are being paid like felt-hatted organization men of the Fifties."

WHAT PAY CAN DO

Before exploring how pay and performance should be tied together (and whether that tying is in itself a good idea) let's back up and ask an ancient question: does money motivate?

The world's developed countries are, in the fullest sense of the word, "cash" societies. The distinction is not between cash and credit but between cash (including credit) and barter–the trading of goods and services without the use of money as a go-between.

In a cash society, every individual must have cash (or the means to obtain it) to survive. Money talks, we say, and indeed it does. What it says is, "Without me, nothing else matters." While our employees may reflect a diversity of talent, color, background, and satisfaction with their jobs, they share this common denominator: with few exceptions, none can afford to be unemployed long. In a cash society, each of us must have a source of cash.

So money is a priority–a Maslovian basic need. Once that need has been met and our basic needs satisfied, money's leverage becomes more tricky and complex.

There are certain areas in which money has a significant impact:

Hiring People: Assuming two different employers are offering similar work, the amount of money paid in salary, commission or wages is probably the single biggest determinant of an individual's choice of which offer to accept. If it is high enough, pay will bring in good job applicants.

Retaining People: Money, in sufficient amounts, will keep people on your payroll. It may not motivate them but it will make them reluctant to leave.

Motivating People: Now the research starts getting interesting. Money can be a powerful motivator of performance, depending on how it's used. If money is used as an expression of recognition, it has the power to generate more and better effort. That's the whole idea behind the "merit increase." Particularly when money comes in the form of a genuine, unscheduled, unanticipated increase that reinforces specific and observable exceptional performance, pay will be a powerful motivator. Doubly powerful, in fact. The money will provide both a reinforcer to the lucky recipient and an incentive to everyone else who discovers that this employer reinforces good performance with generous wads of moolah.

Avoiding Dissatisfaction: Here's the flip side of motivation. If managers can't get genuine motivation, they would at least like to have people who are not discontent. And avoiding dissatisfaction is a worthy and meritorious goal: employees who are dissatisfied waste time, money and both physical and emotional energy. They don't work as hard as they might and they quit when the organization would prefer that they stay. And if they become gravely dissatisfied with their paychecks, they can usually find a union

MANY ORGANIZATIONS PUBLISH A SCHEDULE THAT RELATES THE AMOUNT OF SALARY INCREASE TO THE INDIVIDUAL'S PERFORMANCE APPRAISAL GRADE AND HIS POSITION IN THE MINIMUM-MIDPOINT-MAXIMUM RANGE FOR A JOB.

organizer with a shoulder to cry on. Pay, when perceived as unfair, is a frequent source of organizational malaise. Keeping pay fair inside the organization (internal equity) reduces dissatisfaction. Keeping pay competitive with what other employers are paying (external equity) helps avoid resignations and dissatisfaction among those who stay.

WHAT PAY CAN'T DO

An old management training film illustrating the basic concepts of reinforcement theory provides a classic example of what pay can't do: generate happiness. In a seven-second vignette we see a manager beaming with pride, wrapping up his annual appraisal of an employee's performance. "And that's why," he says to her, smiling as he slides the form across his desk, "I'm able to award you this six per cent raise."

The subordinate reacts as if stricken. She slams her hand on the desk, starts to stomp out, then whirls around and howls, "You call that a raise!"

We may be able to eliminate dissatisfaction with pay. We may even be able to influence motivation. But we can not make people happy. No matter how big the increase, it's never enough. And even if somebody is thrilled at the moment, within a day he'll probably decide that in truth he was underpaid all along and that the organization's apparent munificent increase actually served merely to make him whole.

SATISFACTION AND DISSATISFACTION

It's been almost forty years since Fred Herzberg observed that the opposite of "job satisfaction" is not "job dissatisfaction." It's "no job satisfaction."

There's no semantic sleight-of-hand involved. In simple terms, the absence of dissatisfaction is not the same as the presence of satisfaction. The factors that control one are significantly different from the factors that affect the other. Job satisfaction is mainly a function of the work itself, the opportunities for achievement and accomplishment, the amount of discretion the individual exercises, recognition for achievement, real responsibility, and the opportunity for learning and growth. Job dissatisfaction results from entirely different factors–primarily deficiencies in working conditions, benefits, salary, supervision, interpersonal relations and status.

Awarding a person a salary increase will generally not escalate the individual's satisfaction with his job, unless the pay raise is clearly a true merit increase awarded as a means of providing tangible recognition for genuine achievement. As long as the increase is not so meager as to be perceived as insulting–the organizational equivalent of nickel-tipping an arrogant waiter–what the pay raise will successfully do is remove a significant amount of any unhappiness a person may be feeling. The content of the job is unaltered; only the job context has been changed. The conditions of work have been ameliorated–the work itself remains the same.

While genuine merit increases have the potential to motivate, these types of pay changes will not:

- the regularly scheduled and anticipated annual increase
- a cost-of-living increase, whether scheduled or not
- an increase in the commission paid salespeople
- an increase in the piece rate paid for piecework
- an increase in a regular bonus paid to employees

But what if we label the above, "merit increases?" Will that work?

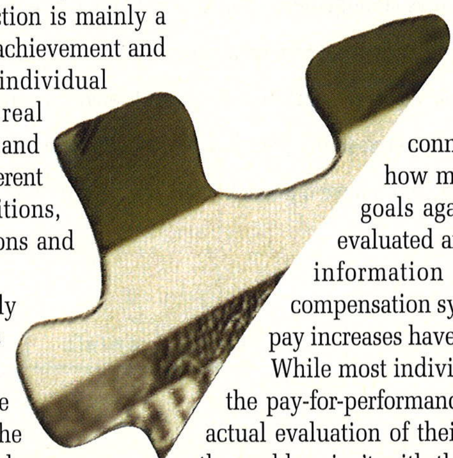
No. Dagwood will be delighted to receive a raise of any kind, whatever label Mr. Dithers may put on it. His dissatisfaction with his pay may be completely obliterated. But if the raise is not truly in recognition of an unusual effort, it will not motivate him to go out and make an unusual effort.

WHY MERIT PAY SYSTEMS FAIL

Pay for performance, competency-based pay, variable pay, pay for skills–all these equity-based reward systems–frequently encounter difficulties in their administration. The cause isn't in the concept but in its implementation. Line managers and compensation specialists together screw up a good idea.

Despite the apparent soundness of the reward-equity theory, experience shows that the actual operating procedures don't work with the elegant simplicity that the theory suggests. Managers make trivial discriminations in salary in spite of major differences in performance. When managers do make significant salary adjustment discriminations, they're often based on factors other than the individual's performance: future potential, length of service, recompense for lack of promotional opportunities, or the perceived need to catch up.

THE RESULT? MANAGERS ARE TEMPTED TO SKEW THE PERFORMANCE APPRAISAL RATING UPWARDS IN ORDER TO JUSTIFY THE AMOUNT OF SALARY INCREASE THEY WANT TO AWARD, RATHER THAN CANDIDLY CALLING THE PERFORMANCE AS IT IS AND LETTING THE RESULTING RATING GOVERN THE SALARY INCREASE.



Many individuals don't see much connection between how hard they work and how much they earn. People often feel that the goals against which their performance is being evaluated are unclear or unrealistic. And the lack of information produced by secrecy-shrouded compensation systems leads people to conclude that their pay increases have little to do with performance.

While most individuals in the organization may agree with the pay-for-performance theory, many are dissatisfied with the actual evaluation of their performance made by their boss. Here the problem isn't with the system itself but with the lack of trust between rater and ratee. Even when rater and ratee agree on the performance rating, the individual may still feel that the proffered reward is inadequate: what the manager considers lavish, the employee may see as insulting. And even an employee who is totally happy with his pay increase will become miserable when she discovers that the sluggards in the organization got the same increase that she did.

PAY AND PERFORMANCE APPRAISAL

The compensation system often ties pay directly to performance appraisal results. Many organizations publish a schedule that relates the amount of salary increase to the individual's performance appraisal grade and his position in the minimum-midpoint-maximum range for a job. The result? Managers are tempted to skew the performance appraisal rating upwards in order to justify the amount of salary increase they want to award, rather than candidly calling the performance as it is and letting the resulting rating govern the salary increase.

A further difficulty arises when the system tightly ties the salary increase amount directly to the appraisal rating. Consider the manager faced with making compensation decisions for two of his employees, both of whom are solidly and accurately assessed to have performed at the Superior level. One of the two is fairly new to the job, has enormous potential, has put in remarkably long hours and has devoted an enormous amount of time to self-development in order to deliver the goods. The other is exactly the opposite: gifted but lazy, he has almost effortlessly coasted to his superior rating. Assuming that both are at the same point in the salary range, do both deserve the identical amount of increase?

What if the first employee is African-American in a field like microbiology or electrical engineering where African-Americans are scarce and the constant targets of efforts to recruit them away? Race may be irrelevant to quality of performance, but should the company's commitment to maintaining workforce diversity rationalize a bigger increase than the performance appraisal rating would suggest in order to assure retention?

And what if the second employee speaks Japanese and the company has secret plans to move into the Japanese market in the next year or two. Japanese language skills, presently irrelevant, will become critically important. Should this currently-superfluous competency be rewarded now in hopes that the employee will be persuaded to remain employed until the day when his skills will be needed?

Leniency and rating inflation are the two most common appraisal errors. Given the natural desire on the part of most managers to avoid conflict and avoid salary dissatisfaction, it is tempting for them to call everyone Superior, award the resulting increases, and get on with things.

MAKING PAY FOR PERFORMANCE WORK

What's the most effective way to encourage honesty in appraisals, to guard against rating inflation and protect against pockets of severe strictness or leniency? Providing guideline percentages may work well. Based either on what the senior management of the organization feel an appropriate distribution of performance appraisal ratings should be, or simply based on previous years' actual distributions, the organization communicates to raters the expected distribution of ratings.

Right on the appraisal form used at the Minnesota Department of Transportation, raters and ratees alike discover that Mn/DOT has indicated the percentage of people who typically fall into each of their five rating categories. Less than 5% are typically Truly Distinguished or Unsuccessful; about 30% are projected to be Clearly Superior. Only 15% typically get a rating of Somewhat Successful while "50% or more" are expected to earn a rating of Fully Successful, Mn/DOT's middle position. There's no forced distribution required, but flatly stating that half or more of all department employees can anticipate a midpoint rating makes it easier for appraisers and appraisees both–and using a term like "Fully Successful" for the middle rating avoids the connotation of average or mediocre.

Alcon Laboratories, one of Fortune magazine's Best Places to Work, doesn't hesitate to publish every year the distribution of appraisal ratings. In one year, 68.5 per cent of all Alcon employees earned the middle rating of GSP–Good Solid Performer (again, what a terrific label for the middle position!). The next year, 69.3 per cent of all Alconers were in the middle group.

Providing guidelines or publishing ratings distributions makes life easier for novice raters and provides an organizational perspective on what an appropriate distribution of performance ratings should be. While any manager who believes that he is managing a stellar unit that deserves to be exempted from the guidelines should be encouraged to state his case, overall the approach generates a great deal of acceptance by both appraisers and appraisees. While no set of guidelines will be appropriate for very small groups, and some supervisors will resent any form of guidance, the approach is sufficiently workable to cover most situations.

TRADE IN THE OLD CLUNKER

When was the last time your performance appraisal system was overhauled? If the current approach has been around for more than four or five years, it's time for a revamp. Revising the complete appraisal system can make sure that the system accurately reflects the competencies needed for competitive success and that goals are focused on achieving corporate strategy. Using an old appraisal instrument is like using an old PC. While that clunky 486 can still run the programs installed on it originally, technology has increased sufficiently that we're frustrated if we're forced to use something that isn't up-to-the-minute.

Training, too, can help. But where training is really needed is at the top of the organization. Senior management needs to be given a job description that lays out their responsibilities for making the performance appraisal system work. At the least, they need to know that it's their job to insist that their direct reports hold subordinates accountable for conducting honest and tough-minded appraisals. They must investigate pockets of leniency when they show up in the organization, and insist that appraisal results be used as the determinants of promotions and increases and terminations.

What do appraisers need? In a word, courage. A quarter-century's experience in teaching managers the skills of performance management has convinced me that skills are secondary. What really is important–far more than skills–is the courage to assess performance honestly and rigorously, rewarding those who excel with the most generous compensation that organization can permit, and bluntly advising non-contributors that up-or-out is their only alternative. S

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