# NewRules: Paying for Performance



By Brad Hill, CCP, and Christine Tande, CCP, Tandehill Human Capital

Pay for performance is a philosophy, not a program, which can be layered on top of existing policies and practices. In some cases, it may be a philosophy that competes with the current philosophy of "paying at market" or "tying pay increases to the cost of living." Companies that want to pay for performance must examine how it will impact some of their time-honored pay practices. Some organizations may decide that there are more important pay objectives than paying for performance.

Part one of this two-part article offers the first five of 10 rules to help organizations pay for performance, while respecting the dignity and contribution of all employees.

## 1. Market pay data must ride in the back.

Choosing to pay at market may hinder a company's ability to pay for performance. Market-pay data has a propensity to go up every year, regardless of how employee performance fares. Given limited pay-increase budgets, companies that choose to increase employee pay based on general market conditions do so at the expense of paying for performance. Market adjustments tend to be a one-way street. Companies use market data to elevate pay levels, but rarely to reflect a downward adjustment in demand. Given limited pay increase budgets, the larger the role in which market data plays, the smaller the role employee performance will play.

### QUICK LOOK

- Choosing to pay at market may hinder a company's ability to pay for performance.
- Companies cannot afford to give base-pay increases for short-term accomplishments, such as achieving annual financial goals or management by objectives (MBOs).
- Under forced distribution, the high performers will continue to perform at a high level, but employees who do not fall in the top category may lose some of their drive.

## 2. Every $1 increase in base pay will be viewed the same as a $5 bonus.

Given limited funds, it is imperative that companies recognize the difference in value between a base-pay increase and an incentive payout. A base-pay increase is a far more expensive reward than a lump-sum payment, and too often companies make the mistake of using base-pay increases to reward one-time, annual contributions. The problem with giving an employee a 10-percent base-pay increase for a terrific year is that the employee earns that 10 percent every year for the rest of his or her career. A 10-percent base-pay increase for an employee making $50,000 (USD) per year who will be around another 10 years is not just a $5,000 increase. It is $5,000 more in pay each year for 10 years, equaling $50,000. And this simple example doesn't even consider the impact of compounding increase on top of increase, or the employee benefits that are tied to base-pay levels.

Paying for performance means tying the term of the reward to the term of the accomplishment. Companies cannot afford to give base-pay increases for short-term accomplishments, such as achieving annual financial goals or management by objectives (MBOs). These short-term accomplishments should be rewarded with one-time, lump-sum payouts. Base-pay increases must be reserved for growth in skills, competencies and responsibilities. A base-pay increase is a long-term reward. Therefore, it must be linked to the employee's ability to contribute more to the organization, not just this year, but in the long term.

Incentives are "look-back" rewards, and base-pay increases are "look-ahead" rewards. If you are providing base-pay increases for past accomplishments, then you are throwing away pay-for-performance dollars and missing an opportunity to reward the employee growth and development that will lead to your future success.

## 3. Cost-of-living changes will have no impact on pay.

Companies have no guarantee that their sales, productivity or profits will go up by, for example, 3 percent next year. So how can they commit to raising their compensation expenses by 3 percent? Compensation is one of the largest expenses for most organizations, and it is irresponsible to allow this category to increase every year at a rate that is unrelated to the performance of the business. As management theorist W. Edwards Deming, Ph.D., noted, "Employees have it backwards — instead of their wages being adjusted to account for their cost of living, their cost of living should be adjusted to account for their wages." Part of the reason companies are hamstrung in paying for performance is that they accept a "cost-of-living floor" on wage increases. When there is a minimum percentage expectation, that doesn't leave much room to recognize the top performers.

## The Employee Investment

Investing in an employee is like investing in a company. Think of base salary as the stock price and incentive pay as the dividend. If a company has the same performance year after year, its stock price will remain flat. The annual performance may generate a profit, but this alone will not be enough to move the stock price. (Although this is often enough to justify paying a dividend).

It is only the companies that continually can improve their ability to perform in the long term that realize steady increases in stock price. And, it should only be employees that continually improve their ability to perform — by learning, growing and taking on more responsibility — that realize steady increases in base pay.

### 4. Incentive pay opportunity will be based on the "performance risk" associated with the job, not the organization level.

Incentive pay is a tool to help companies manage performance risk. Performance risk is the difference between what we expect a job to contribute and what it actually contributes. In jobs where there are small differences between expected and maximum contributions (i.e., accounting) there should be small incentive opportunities. In functions where there are large differences between expected and maximum contributions (i.e., sales) there should be large incentive opportunities.

The sales function is an interesting example because there is typically more performance variability at the lower levels of the sales organization than at the higher levels. Therefore, it is reasonable that, for example, incentives make up a larger proportion of total pay for the sales representative than for the sales manager.

In examining incentive-pay opportunities, organizations should first examine the range of potential performance for the job, and then consider the organization level.

### 5. "Forced ranking" of performance cannot be used, unless there is an employee-assistance plan to deal with the demoralized.

If a company intends to communicate that 10 percent or more of its workforce is failing on an ongoing basis, then it must have a plan to deal with the demoralized, fragile psyches of workers. Forced ranking pits employee against employee in a competition for who gets to keep his or her job. It's the opposite of teamwork.

The problem with forced ranking begins with the organization's hiring practices. An organization does not randomly hire employees. Therefore, it should not treat its workforce as if it represents a normal distribution of performance. Companies do not hire people that they believe will fail. Good companies hire against a competency profile of success. They screen candidates and select people who best fit with the needs of the organization. Forced ranking is a lazy solution to problems created by poor hiring practices and an inability to develop people.

That being said, companies that use a forced-ranking methodology probably do a better job of paying for individual performance than those that do not employ forced ranking. But in their zeal to pay for individual performance, these organizations often harm overall performance. Under forced distribution, the high performers will continue to perform at a high level, but employees who do not fall in the top category may lose some of their drive. Employees in the middle may feel the most demoralized by the forced-evaluation rankings because they do not want to be considered average. Those employees in the bottom categories are less likely to have the energy to recover and make a commitment to improvement, than to check out, look for another job or spread the word on how unfairly they have been treated.

Forced ranking is a terrific tool to pay for past individual performance. But the price for this "pay-for-performance moment" is a workforce that likely will underperform in the future.

### Making a Change

Pay for performance is not a plan or program, but a philosophy that may be contrary to many of the policies and practices that companies and employees hold dear. Companies talk a lot about paying for performance, but few are willing to break with the traditional market-pay practices that define and reinforce mediocrity. For the nonexecutive population, organizations choose to play it safe rather than develop an offering that will excite prospective employees and differentiate the company in the marketplace.

Part two of this article will focus on rules six through 10 and uncover more ways for you to ensure your organization is truly paying for performance. WS

**ABOUT THE AUTHORS:**

Brad Hill, CCP, is principal at Tandehill Human Capital and has been a WorldatWork member since 1985. He can be reached at brad_hill@tandehill.com or 630/258-0295. Christine Tande, CCP, is principal at Tandehill Human Capital and has been a WorldatWork member since 1999. She can be reached at christine_tande@tandehill.com or 630/836-0895.

**RESOURCES PLUS**

For more information related to this article:

Go to www.worldatwork.org/advancedsearch and:

- Type in this key word string on the search line: Pay for performance.

Go to www.worldatwork.org/bookstore for:

- *Forced Ranking: Making Performance Management Work*
- *How-to Series for the HR Professional: Understanding Performance Measures*
- *How-to Series for the HR Professional: Linking Pay to Performance.*

Go to www.worldatwork.org/certification for:

- C11: Performance Management — Strategy, Design and Implementation.