



HR Magazine: (Top) Pay for (Best) Performance

By Steve Bates

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In the sluggish economy, compensation system gets new focus by rewarding star performers more than the rest of the pack.

Like many companies, fiber optic cable manufacturer Corning Inc. is struggling financially. Sales are way down. Its stock price recently dipped to just over \$1—about 1 percent of its value three years ago.

Executives have slashed more than 16,000 jobs in two years and have frozen salaries for everyone who's left.

But while the Corning, N.Y.-based company hasn't had a profitable quarter since early 2001, next month it will give bonuses to employees who met their goals this year.

Why reward employees for a disastrous year?

The answer, says Corning, is that rewarding good workers is the best way to increase productivity and to secure dominance in its potentially lucrative market. The bonuses will likely be very small this year. But the payments will fulfill a promise to the workforce that better employee performance results in better compensation.

Forward-thinking companies are using the sluggish economy “as a time to capture market share, to do things that aren't common” in their industry to gain competitive advantage, adds Thomas B. Wilson, president of Maynard, Mass.-based Wilson Group consultants, a firm specializing in consulting on performance-based total reward systems.

In fact, compensation experts argue that paying for performance is more important in a down economy than in boom times. The reason is that companies typically have a smaller pot of money to allocate for compensation during a slowdown. So, instead of giving everyone an equal but minimal increase to their base pay, some organizations are dishing out salary increases, bonuses or both in varying amounts, with the most going to the best performers or to the most essential employees. In some cases, poor performers get little or nothing above their base pay.

“For the first time, companies truly have to differentiate” among their workers in a visible, dramatic way, says John M. Bremen, national compensation practice leader for consulting firm Watson Wyatt Worldwide in Chicago.

Compensation experts urge companies to take this opportunity to move farther from a system that relies heavily on across-the-board merit increases to one that focuses on rewarding top performers substantially more than the rest of the field. Companies need a compensation system that catches a top performer's attention and sends a signal to a poor performing employee. To

do this, the system must differentiate between the two.

“We can’t think of a better time in the last 20 years to talk about this,” says Peter LeBlanc, senior vice president of Sibson Consulting in Raleigh, N.C. “It’s a major opportunity for companies now.”

The devil is in the details, however. Executing such a system can be treacherous.

Seizing the Opportunity

Performance can be assessed based on individual or team contribution, on business unit results or on corporate profit or share price. It can be rewarded through traditional salary adjustments but also through variable pay techniques such as one-time or recurring bonuses.

Surveys show that about two-thirds of U.S. companies have some sort of variable pay, and about 10 percent of all compensation is variable.

Rewarding “top-performing employees” does not mean rewarding solely high-level employees. Organizations are using performance pay for middle managers, professionals and hourly workers, determined not to let the depressed business climate lead to a depressed workforce.

“It’s not an economic issue. You need performance whether it’s a good economy or a bad economy,” says Ed Lawler, an author, professor and director of the Center for Effective Organizations at the Marshall School of Business in Los Angeles.

Paying top pay for best performance is a marked shift from just a few years ago. Many firms established generous but somewhat haphazard pay systems when the economy was hot in the 1990s. “We were just throwing money at talent,” says Jay Schuster of consulting firm Schuster-Zingheim and Associates in Los Angeles.

Today, “companies are being much more careful about who gets incentive pay,” says Bremen. In some organizations, “we’re seeing fewer people getting variable pay. Those who are getting it are getting more than they did before.”

Some experts say this increased use of performance pay could mark the end of an era of entitlement in employee compensation. The bedrock of that era has been a merit pay system predicated on lifetime employment with steadily rising, virtually equal wages for all workers in a grade or job category.

The shift from a manufacturing economy to a knowledge-based economy, a more mobile workforce and the economic downturn have changed the way people look at pay, experts say.

“People used to fear the day that merit increases went below 10 percent, then 5 percent. We’re now dealing with numbers so small that it is difficult to differentiate” between the best and worst performers with traditional salary adjustments, says Bremen.

Research shows that “you need [a] 7 percent or 8 percent [compensation increase] just to catch anybody’s attention,” says Robert Heneman, a professor of management and HR at Ohio State University. Anything below that is welcome but doesn’t lead to significantly greater effort on the part of the employee to drive business results.

In fact, giving all of an organization’s workers an annual merit salary increase of about 4 percent “is a joke,” says Wilson. “The after-tax difference is a Starbucks coffee.”

For many years, agrees LeBlanc, “we have been guilty in corporate America of spreading it evenly like peanut butter. Why do we put a merit increase in base pay?” he asks. “It ceases to be base pay. We’ve handcuffed ourselves and lost our imagination.”

Brad Hill, senior consultant with the Hay Group in Chicago, offers the following example to illustrate the difference creativity in

compensation can make: Consider a firm that gives each worker a 5 percent salary increase each year for 10 years. Instead, reduce that raise to 3.5 percent per year. Because the firm is not compounding the larger raises year after year, it can give each employee an annual bonus of 7.2 percent of salary in addition to the 3.5 percent raises—for the same total outlay over the decade.

Now take it another step: With the same overall compensation budget, reward your top performers significantly more with higher salary increases and larger bonuses while giving your average and poor performers lower salary increases and bonuses—or no bonus at all. For a detailed example of how this can be achieved with nearly the same compensation outlay, see the sidebar "**Reward the Best, Prod the Rest**" (www.shrm.org/Publications/hrmagazine/EditorialContent/Pages/0103covstory.aspx).

Hard to Understand, Execute

Paying for performance does more than deliver the best financial rewards to the best workers. When done right, it sends a vital message about the organization's priorities and values, experts say. "Compensation is really one of the main communication vehicles between companies and employees. Companies forget this," says Bremen.

Indeed, it seems top performers aren't getting the right message. A recent survey by Watson Wyatt reported that fewer than 40 percent of top-performing employees believe that they receive "moderately or significantly better pay raises, annual bonuses or total pay than do employees with average performance." The same survey found that companies providing variable pay to their best workers are 68 percent more likely than other firms to report outstanding financial performance.

According to Russell Miller, a principal with Washington, D.C.-based Mercer Human Resource Consulting, a well-crafted performance pay system establishes a pact with workers that says, in effect, "We're going to hold you accountable, and we're going to reward you." Employees will share in the fruits of business success, but they also will share the risk of belt-tightening. It's both carrot and stick.

"That's a major leap," adds Miller.

But few companies get it right. While traditional merit pay is designed to reward workers for past performance, performance pay attempts to motivate future behavior, which is less tangible. Therefore, performance pay is not well understood or well executed by many firms, say academics and consultants. "Even the financial people aren't recognizing the potential," says Hill.

One reason HR professionals and line managers might be hesitant to use performance pay to its full potential is that taking money away from one individual or group of workers to fatten the checks of another can be disruptive or demoralizing. People talk, and they often know who gets the big payout.

But Monica Barron, a senior analyst at AMR Research, a Boston-based business consulting firm, argues: "It's OK for people to know that. You should make your best performers role models and say to the others: 'Here's what you can do to get one of these checks.'"

Ken Abosch, talent business leader of consulting firm Hewitt Associates in Lincolnshire, Ill., agrees. "Maybe there's a fear [in HR] that employee satisfaction will be cut. We're trying to improve performance," not satisfaction, through performance pay, he says. "Sometimes we need a healthy dose of tough love."

And while changing any pay system is risky, says Miller, "the biggest risk is mediocrity" if a company fails to reward its top employees adequately. "Your stars are going to look elsewhere, and your average and below-average employees will say 'I'm going to stick around.'"

Another hurdle to establishing performance pay is determining what a company wants to achieve through its compensation

plan. "One of the symptoms of a poor performing company is the inability to set goals effectively," states Bremen. "A compensation system cannot resolve inadequate goals setting; it actually makes it worse."

In addition, the corporate culture has to accept this kind of reward/risk system. "First you have to build a culture of high performance," says David Balkin, chair of management at the University of Colorado at Boulder. "Pay works best when it follows other changes that have already been made in the culture. It legitimizes; it's the final cementing of that change."

"The variable pay risk should be commensurate with an individual's ability to impact results," adds Bremen, and workers should see clearly how they can accomplish what's asked of them.

Education and communication are critical to this process. "You need basic communication about what you're trying to do and how the employee can help you get there," says Barron.

Employees who are knowledgeable about a performance pay plan not only show better individual performance but also can explain it to their colleagues, notes Hill. "You need to identify disciples in every element of the organization to talk up the program."

Hill favors involving employees in the design of a performance pay system, albeit with some guidance from managers and perhaps a consultant. "I've been very impressed" by plans that employees help develop. "About half the time the plan they come up with is the plan I would have come up with."

Employee participation was crucial to the development and success of the incentive pay plan created at Corning. Called "goalsharing," the system establishes specific performance standards for workers in each business unit. These are re-evaluated annually, and payments are made annually to employees who meet their goals. (See "**Goalsharing at Corning** (www.shrm.org/Publications/hrmagazine/EditorialContent/Pages/0103covstoryb.aspx)")

Goalsharing is not the same as "gainsharing" where employees typically get a set percentage of business unit or corporate profits in addition to base pay. In addition, individuals, small teams and large teams in gainsharing programs can earn variable pay increases based on their contribution to business success.

Emphasis on Measurement

Perhaps the greatest challenge in establishing and using performance pay systems is identifying and quantifying the job performance factors that can be linked directly and meaningfully to the organization's goals. It's all about measurement.

"A company's culture becomes formed around how you measure," explains Miller. "You've got to make sure that what you measure is what you want.

"It's not easy," he adds.

Establishing performance pay systems has been easiest in organizations or units where job performance and results are easiest to see and quantify, such as in sales. "It has been a very sales-oriented concept," says Mike Lieberman, vice president of marketing at compensation software and services firm Synygy in Conshohocken, Pa. Today, his clients' managers in non-sales departments "are seeing some similar advantages."

"There is a lot of traction in organizations that face the customer and where there are quantifiable metrics," adds Barron. For example, in a customer relations call center, managers can record the number and length of calls handled by each worker or each group of workers and can survey customer satisfaction levels. Those results can factor directly into call center employees' compensation.

Schuster suggests creating a list of the critical skills needed in good times and bad times. "Identify the people who are market

leaders in those skills,” he says. “It could be people in the hourly ranks.”

Such an approach “might sound harsh” to other employees, says Schuster, but these are harsh times.

“There is no magic formula for how organizations go about using variable pay effectively,” says Abosch. Each organization has to look objectively at its financial goals and at the employee behaviors that drive the desired results. Each has to identify a few measures—some experts say no more than three to five—that the worker and line manager and other managers can agree on as crucial to linking individual performance and business success.

The Role of HR

In some organizations, HR departments are integrally involved in proposing, designing and implementing performance pay systems. But even where HR is not at the forefront of such efforts, it still can play a role.

Sibson’s LeBlanc views performance pay as “the best opportunity for HR departments to take a good look at what they’re doing and to challenge the entitlement mentality.” In doing so, says LeBlanc, “HR should educate and up-skill the manager first.”

To do this, HR can help managers “give people the information they need to see themselves and understand what they need to do,” says Wilson. “HR can be the catalyst for managers who want to do something different.”

Compensation is of critical importance to the viability of a business. HR departments are “essentially managing the biggest cost center that most organizations have,” says Schuster. “This is without a doubt the most incredible opportunity in a decade for the profession to demonstrate its value and create a whole new generation of HR professionals.”

Steve Bates is senior writer for HR Magazine.

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