
PayScale
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STRENGTHEN
the
LINK BETWEEN
PAY & PERFORMANCE

PERFORMANCE -

AT PEAK LEVELS, IT PUSHES ATHLETES AND BUSINESSES TO THE SUMMITS OF SUCCESS. AT ITS LOWS, BUSINESSES SLOWLY STRUGGLE TO GAIN MOMENTUM AND FALL BEHIND THEIR COMPETITORS. THE SUCCESS OF YOUR ORGANIZATION DEPENDS ON THE PERFORMANCE OF YOUR EMPLOYEES.

As a leader within your organization, what can you do to drive performance?

One motivational concept revolves around developing a pay-for-performance strategy where employees are evaluated and rewarded based on the completion of individual, team or organizational goals.

56% OF COMPANIES USED PAY-FOR-PERFORMANCE STRATEGIES IN 2012.

Pay-for-Performance Defined

Two opposing philosophies have traditionally dominated the compensation world. One is based on tenure and the other on rewarding performance.

In a tenure-based compensation system, pay is often defined by time in position, without serious consideration for an employee's individual performance. It's assumed that if you are still in your position, you are deserving of an increase and therefore that increase is automatically granted.

On the other hand, there's the pay-for-performance philosophy which according to The World at Work Handbook of Compensation, Benefits & Total Reward, "links pay (base and/or variable), in whole or in part, to individual, group, and/or organizational performance."

Pay-for-performance models take a much more strenuous route than tenure-based compensation philosophies, emphasizing performance as the deciding factor in defining pay increases. With a pay-for-performance system there's no guarantee that employees will receive a pay raise, and individuals in the same job position have the potential to be compensated at opposite ends of the pay range from each other. Performance-based structures permit companies to compensate top performers well above average and to provide cost-of-living adjustments or no increase at all for below average performers.

Why Bother with Pay-for-Performance?

In PayScale's 2013 Compensation Best Practices Survey, performance was the number one reason most companies gave pay raises. Of companies participating in the survey, fifty-six percent reported performance-based pay increases as their main reason for raises—an increase from 2012, when forty-eight percent of companies claimed to give performance based pay raises.

So, why are more companies making this move to pay-for-performance?

1. Cost efficiency.
2. To motivate employees.
3. To drive results.
4. The principle of it.

ROLL YOUR SLEEVES UP BECAUSE PAY-FOR-PERFORMANCE IS NOT AN EASY THING TO GET GOING.

Among some circles, pay-for-performance is considered the “holy grail” of pay structures. The concept is especially enticing because it is built upon an ideal premise that is hard to disagree with – employees who perform better should get paid better. The idea often appeals to executives because they see it as a way to more strategically allocate resources and apply budget allocations where they see a return, i.e. employees who are driving results within the organization.

As an employer you want to see how your expenses are driving your company forward, and affecting your bottom line. Since labor is the largest expense for most organizations, it makes sense that more organizations want to strengthen the link between pay and performance and monitor the return on labor expenses. With a well-crafted pay-for-performance program, companies can more strategically allocate their budget where they see the most return.

Not only can this strategy save companies money, but a well-crafted pay-for-performance approach can also help unite employees toward a common goal and help them understand how their contributions lend to the company’s success.

Pay-for-Performance Naysayers

Some detractors of performance-related pay models will tell you that more pay-for-performance models have been attempted and failed than succeeded. In fact, author Dan Pink, has gone so far as to state that pay-for-performance models just don’t work at all. Dan states that performance compensation plans actually hurt performance for most tasks and that for tasks requiring creativity and unknown solutions (basically knowledge work), performance actually decreases with traditional carrot and stick management.

Here’s the crux of pay-for-performance — it’s not an easy thing to establish in an organization. Establishing an effective pay-for-performance program takes time, careful planning and serious hard work to implement. If your organization is not prepared for either of those, it’s best to turn around.

ARE YOU REALLY READY? BEFORE YOU BEGIN, MAKE SURE TO DO THE READINESS AUDIT ON PAGE 10.

Here are the 3 most common barriers to success:

1. Lack of Executive Support

Executive leaders often see pay-for-performance system (or any HR program) as a way of limiting their authority or range of options. Even if you have buy-in from the beginning, it's important to continually reinforce the importance of pay-for-performance to your executives.

At the end of this whitepaper you'll find a series of questions for conducting a readiness audit. We suggest going through that list with your executives before starting, as it will help you clarify goals and objectives are, and help you assess whether or not your organization is ready to pay-for-performance.

2. Lack of Manager Training

Your managers are the ones who will need to back up your strategy and communicate it to your employees. Therefore, they need to be trained on how to have tough conversations around pay when employees don't qualify for a pay raise based on their performance, and they need to be able to justify those decisions. If your managers are simply telling people "Sorry, they won't let me give you a raise," that doesn't serve the overall strategy. Your company's managers need to be able to tell employees why they are not getting a raise, and what they can do about it to improve their performance in the future.

3. Perceived Budget Restrictions

There is a common misconception that rewarding performance will cost the company more money. That could be true, if you do it wrong. However, if you make a commitment to only putting your compensation dollars where the work is, and not rewarding under-performing employees, it generally works out to save money.

Another important factor to consider into the equation is the cost of turnover. If you don't pay your top performers what they are worth, your competitors will. The cost to replace an employee, in terms of recruiting, lost work, missed deadlines, etc. most certainly will outweigh the cost of rewarding them appropriately to start.

5 Checkpoints on the Road to Success

Now that you know the barriers, let's talk about the main avenues to success.

1. Get Executive Buy-in

Get the people at the top involved in your plan early. Your leadership must agree on the overall philosophy, support the business goals you are trying to achieve, understand how to track the progress of these goals, and decide how much budget can be used to incentivize these goals. It's important to get your leadership team to develop as much clarity around these questions as possible. At the end of this whitepaper, check out the Readiness Audit, for a list of questions to ask.

2. Align with Organizational Goals and Culture

Pay-for-performance models are most effective when the goals and performance measures are related to the overall business goals and desired outcomes versus tasks. This is the part where many pay-for-performance models completely miss the boat. This is the nexus – the place where human behavioral science and business meet. Making this work involves providing clearly articulated goals, a sense of purpose, and increased individual, group, and overall enterprise accountability.

Achieving complete alignment with business goals and organizational culture is much easier to talk or write about than to do. This type of alignment takes commitment because it means starting from the highest aspirations for your organization and working your way down to identifying and inspiring the smallest outcome and/or behavior that will get you there, but once achieved actually moves profit forward.

Organizations must ask themselves:

- What is it that we really, really, want to be?
- How do we get to be that?
- What will we need to do?
- Who will we need to do it?
- And, how will they do it?

It is that final question that becomes the basis for managing, measuring, and compensating your people for performance.

PAYSCALE HAS YOUR BACK IN TOUGH EMPLOYEE CONVERSATIONS. FRESH, DETAILED MARKET DATA AND EASY REPORTING MAKE THOSE TOUGH EMPLOYEE CONVERSATIONS SIMPLE AND EFFECTIVE.

3. Get Right Systems in Place

This includes having the right people to make it work and the tools to give them the confidence to have the tough conversations and say, "You're not getting a pay increase, because you're not performing."

The right tools are an important part of this equation also. With software that can help you place employees in their market range, and account for performance, deciding whether or not they should be rewarded become a lot easier.

A critical system to have is a good performance evaluation, but that can be as simple as an "exceeds, meets, does not meet expectations" rating.

4. Train Managers Properly

You also need to get your managers bought in and trained. They need to know that the pay-for-performance program has support from the very top of the organization. Your managers are the ones who will be having the one-on-one conversations with employees. If they cannot explain to an employee why they are not getting a salary increase, you're going to have problems. The last thing you want is a manager sitting across from an employee saying, "Well, I'm giving you a one percent increase. I don't know why, but my hands are tied. I wanted to give you more, but they won't let me." Managers need support from HR in the forms of training, talking points and calibration exercises.

5. Communicate Clearly Across the Organization

The most crucial moment for communication is during the performance appraisal. When a company decides to start using a pay-for-performance model, they need to openly communicate how the new system works. This is especially true for companies who have traditionally given across-the-board increases to all employees. Sometimes, showing employees a sample job performance matrix is helpful for explaining to them the direct relationship their performance has on their pay. See next page for an example.

ELIMINATING ACROSS-THE-BOARD PAY INCREASES IS ONE THING YOU CAN DO RIGHT AWAY.

Get Started: Four Things You Can do Right Now

There are different ways to infuse compensation into the performance plans so that the performance plans are based on real data and tied to consequences (good or bad). Here are four things you can do to begin instilling pay-for-performance in your base pay plans.

1. Eliminate Across-the-board Pay Increases

For most organizations, across-the-board pay increases, where everyone gets the same percentage increase, is the death to a pay-for-performance plan. A common problem with this kind of approach is that salary raise budgets are limited and are allocated based on arbitrary things that can't actually be associated with the achievement of business goals. By continually giving "across the board" style pay increases, many companies end up with employees who are grossly over their salary range, leaving little budget available to allocate to employees who are actually driving the business forward.

Eliminating across the board pay increases is one thing you can do right away to get the ball rolling towards a pay-for-performance culture.

2. Build a Merit Matrix that Rewards the Behavior You Want

If you're not already using one, you may want to consider creating a merit-based performance matrix (MBM). The merit-based, pay-for-performance matrix serves as a guide for supervisors so that they may suggest pay increases that are fair and support business objectives. The merit matrix connects performance to market rate pay.

Merit-Based Performance Matrix: Placement Relative to the Market Rate

PERFORMANCE	BOTTOM THIRD	MID THIRD	TOP [illegible] EXAMPLE
Exceptional	6% Raise	4% Raise	3% Raise
Average	4% Raise	3% Raise	2% Raise
Below Average	2% Raise	1% Raise	0% Raise

> "ONCE YOU PAY PEOPLE ENOUGH, HOLDING OUT ADDITIONAL, SMALL AMOUNTS OF MONEY IS NOT MOTIVATING."
>
> - DANIEL PINK

Employees on the top left are high-performers at your organization who are currently greatly under-compensated in comparison to the marketplace. Your goal should be to bring their pay up to market standards as quickly as possible. Employees who are closer to the market, towards the right, can be brought up more slowly. Employees in the median range of pay with satisfactory performance won't be recommended for an increase.

In this challenging situation, the manager must explain that the possibility for further performance improvement and pay increase does exist and is encouraged.

A great time-saver for organizations using pay-for-performance models is PayScale Insight cloud compensation software which shows each employee's performance, pay, and how their pay relates to their position and industry – the exact kind of information managers want when determining merit pay increases.

3. Differentiate Rewards Enough to be Meaningful

What often happens is that companies will build a merit matrix and target people in their range, but there won't be enough differentiation. That's a difficult situation. Though to you, it may look like you're trying to do pay-for-performance, to an employee it doesn't appear that way. To an employee, the difference between a 1% and 2% increase is not a motivating factor. SHRM suggests that the difference in pay needs to be at least 7% to be meaningful.

4. Remove the Word Longevity from Your Pay Philosophy Vocabulary

Challenge your senior leadership to look at proficiency, not longevity. A lot of executives get stuck in the mentality of awarding longevity, rather than proficiency. And it is proficiency at a job that actually dictates the value of the employee, rather than their longevity.

The Readiness Audit: Nine Questions to Answer Before You Start

It should go without saying that compensation is a sensitive subject, and any change that affects the amount of money in someone's paycheck should not be taken lightly. There are few, if any, topics that are more personal to an employee than how much they make and their ability to support their family or lifestyle.

Before you shift to a pay-for-performance pay strategy, ask these nine questions to see if it's right for your organization.

1. What do we want to reward in our organization?

If the answer is longevity or tenure only, then take a pass and do not continue. A combination approach of rewarding tenure and performance is okay.

2. Why is pay-for-performance right for our organization?

This will help you clarify expectations of pay-for-performance by others. It's good to get this out on the table as soon as possible, so people's expectations are in alignment.

3. How will we change the mindset of employees to accept this change?

You need to get an idea of how clued-in your senior leadership is to the difficulty of a fundamental change like this.

4. What does success look like?

This is where you define your goals of the plan. Make sure you know what the key performance indicators are. You need to know this from the very start, otherwise you'll struggle to develop meaningful goals for your employees, and have no idea if the program is a success.

5. How will we respond to employees who feel like we are disrespecting loyalty or their financial wellbeing?

It's worth repeating that any change that affects the amount of money in someone's paycheck should not be taken lightly, because your employees will not take it lightly either. You can do everything by the book, but if you fail to properly communicate these changes to your employees, your pay-for-performance plan could crash and burn in the form of high turnover.

6. Who will be involved in driving this initiative? Is it just you?

If so, it's going to be an uphill battle. In order to develop a useful program, this needs to be an initiative that has buy-in from leaders, and multi-level support.

7. Do we have the right managers in place to reach successful outcomes?

Sometimes that means having people who can have honest conversations about pay, and are able to say "You're not going to get a raise because you haven't been performing." Those same managers also need to be able to say "This is what you can do to improve your performance."

8. Can we afford this?

This question applies beyond just monetary costs. But with time. Plus, it's also important to flip this question on its head and ask your leaders, "Can we afford not to do this?"

9. What could go wrong, and what outcomes are we unprepared to deal with?

You're better off knowing this now, rather than two weeks after you've rolled out your plan. Be ready.

Find out how to make pay-for-performance easier using PayScale Insight.

GET A DEMO

About PayScale

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