ABANDONING PAY-FOR-PERFORMANCE MYTHS IN FAVOUR OF EVIDENCE

One reason rewards do not perform as intended is that executives and the reward professionals who support them have relied time and again on a group of compelling myths when structuring programmes, despite long-standing, high-quality behavioural science research that calls these "principles" into question. This article makes the case against five persistent myths, citing research and reviewing case studies, and considers circumstances in which reliance on them is most likely to diminish productivity. The article's objective is to encourage reward professionals to consider their own programmes and whether they are achieving intended objectives on a cost-effective basis.

To make the case clear, consider a situation presented in the *Journal of Legal Studies*.[1] A child care centre wanted to reduce the number of parents who were late picking up their children. So the centre established fines for late pickups. Contrary to expectation, late pickups significantly increased after the implementation of the fines. When the fines were later abolished, late pickups remained at the new, higher level. What happened?

Before the fines, parents who had personal relationships with the teachers were intrinsically motivated to be punctual. But the fines caused parents to redefine the situation from a moral obligation ("be fair") to a financial transaction ("I can pay for extra time"), and once their perception of the situation changed, the previous motivator was not easily re-established. The bottom line: incentives are complex, and left untested, design "instincts" can be plain wrong.

This example shows how oversimplistic thinking on reward can so easily result in unintended consequences and that there are great dangers in applying universal principles to reward. Each business situation is different and human behaviour is complex and difficult to predict. Each of our five myths has elements of truth, but in this article we show the damage that can be done if they are believed to apply in all situations.

[1] Gneezy U and Rustichini A. "A Fine Is a Price," *Journal of Legal Studies*, Volume 29, Number 1 (2000), pp. 1–17.

MYTH NO. 1: FORCED DISTRIBUTION PROMOTES HIGH PERFORMANCE

Many companies force a prescribed distribution of performance ratings along a "bell curve", minimising the high ratings at one side of the bell, massing the majority of ratings in the middle, and ensuring application of the lower rating categories. While this conventional approach is generally considered a required step in moving to a "performance culture", the reality is that a forced distribution can inflict serious harm.

Forced distribution does have potential benefits. In forcing managers to use all rating categories, it requires them to address performance and development issues and to provide feedback in the context of the delivery of those ratings. It also leads to recognition of the "best of the best" in high-performing organisations, which can ensure that efforts are made to attract, retain, and fully develop/use such employees.

Where it is possible to recruit capable replacements, the managing out of poor performers by means of forced distribution can generate short-term gains. Simulations show that the gains from replacing forced-out terminations with new recruits from the market can fall to zero within a few years of programme implementation[2]; still, the greater the impact of employee performance on productivity, the greater the benefit of such efforts. Perhaps for some, forced distribution will provide a nice productivity jolt in the period immediately following its adoption.

On the negative side, in deviating from the actual performance distribution, forced distribution can generate a perceived lack of "due process" and demotivate top talent, leading to exits — a particular concern when important contributions can only be evaluated at the end of cycles spanning multiple evaluation periods.

In terms of managerial behaviour, leaders might be driven to retain (or even recruit) underperformers so that they can protect their "stars", diminishing the potential of the policy to promote high performance. At perhaps the most corrupting level, limited high-performance ratings may not even be assigned to the highest performers — when supervisors spread limited designations available to them among valued employees over time; for example, "It's his turn for a high rating."

Mercer's employee survey research shows that, when asked what HR practice they would most like to change, a significant percentage of respondents would eliminate forced distribution. Further examination shows that they view such systems as unfair (even to those getting the high ratings) and a deterrent to teamwork, innovation, and risk-taking.

For an organisation concerned about the retention of key talent, statistical models run to identify the most important antecedents of turnover — when various factors were

[2] Scullen SE, Bergey PK, and Aiman-Smith L. "Forced Distribution Rating Systems and the Improvement of Workforce Potential: A Baseline Simulation," *Personnel Psychology*, Volume 58, Number 1 (2005), pp. 1–32.

considered simultaneously — showed that high performers were suddenly more likely to leave, relative to others, following the implementation of forced distribution.

Though one can argue that the organisation's high performers were now fewer and therefore appeared more "marketable" on a relative basis, particularly in a weak economy, additional analysis showed that larger incentive payouts were also suddenly associated with increased attrition.

Those getting high ratings and payouts were concerned that they would not see the same outcomes in the next year, as supervisors spread such designations and wealth among teammates over time; indeed, the correlation between payouts over time had declined. (For more on such statistical models, as applied to archival workforce data, see *Play to Your Strengths: Managing Your Company's Internal Labor Markets for Lasting Competitive Advantage*.[3])

Perhaps most critical for the success of forced distribution is the need to couple it with appropriate manager training. Having properly trained managers ensures that the desired feedback implicit in the implementation of the practice is delivered with appropriate care to achieve developmental objectives, all without undermining effective collaboration.

What else should be done differently to ensure that forced distribution promotes high performance?

- Identify clear criteria for differentiation, which should include consideration of multi-year contributions.
- Move from forced distribution to "expected distribution" in which the actual distribution can be varied, depending on team and/or business performance.
- Apply forced distribution evenly at each level, to ensure credibility.
- Have a three-year game plan — setting a target to manage a certain number of employees out of the organisation each year is not sustainable.

MYTH NO. 2: CAREER REWARDS DO NOT MOTIVATE

The designers of reward programmes tend to put more emphasis on current payouts rather than "career rewards", especially for younger employees (millennials) who are perceived to have high, immediate expectations. "Tournament theory", first described by leading economists Edward Lazear and Sherwin Rosen in 1981,[4] depicts an environment in which future pay, driven by career progression, strongly motivates employees. Even among younger employees, there will always be those with longer-term orientation who can be motivated and "selected" through such emphasis.

The theory depicts "higher-ups", who are paid more than their value in order to motivate less senior employees — the lower-level employees compete to fill those highly paid jobs in the future. This "tournament" reward system, with its varying levels of motivational effectiveness across organisations, exhibits the following characteristics:

- Promotions are based on relative performance — that is, employees compete for a limited number of higher-level positions in each period.

[3] Nalbantian HR, Guzzo RA, Kieffer D, and Doherty J. *Play to Your Strengths: Managing Your Company's Internal Labor Markets for Lasting Competitive Advantage*, New York: McGraw-Hill Professional, 2003.
[4] Lazear EP and Rosen S. "Rank-Order Tournaments as Optimum Labor Contracts," *Journal of Political Economy*, Volume 89, Number 5 (1981), pp. 841–864.

- There is a heavy reliance on internal candidates to fill senior jobs — an organisation that generally brings in people from outside would have a much less effective tournament.

- Rewards rise with level, at an increasing rate — to increasingly motivate employees as performance thresholds become tougher. (Such rises become more difficult to explain at higher levels based on the direct examination of the relative productivity of promotees.)

Figure 1 depicts a rewards structure, across hierarchical levels, that would be characteristic of a tournament. For those higher up, greater incentive payouts compensate for the more limited opportunity to advance. In company-specific analyses conducted by Mercer, recently promoted employees were found to be no less likely to quit than others and misalignments of this "career reward" trajectory (in reality or in employee perception) were found to be responsible. For an example, see the case study in the paper "Rethinking Careers to Enhance Business Success".[5]

Figure 1
Total Expected Annual Compensation (by Hierarchical Level) in a Tournament

Recommendations for effective use of tournaments to motivate employees include the following:

- Ensure that reward trajectories deliver value as employees progress.

- Make reward trajectories (more) transparent so that they can directly motivate employees.

- When promotions are infeasible, provide employees with developmental opportunities through training and/or lateral job-change opportunities.

- Be cautious in market-pricing senior jobs, given that tournaments will create a gap between pay levels and market rates.

[5] Levine B and Nugent K. "Rethinking Careers to Enhance Business Performance," *WorldatWork Journal*, Volume 14, Number 3 (2005), pp. 61–63.

- Use tournaments and relative performance evaluation when collaboration is not critical and to generate cost savings by leveraging money spent on a subset of employees to motivate a larger group and by insulating employees from "systematic risk" that would equally limit the performance of all peers.

As a side note, perceptions that executives are overpaid can be partly refuted by tournament theory: executive pay serves to motivate those below. Relative performance considerations are also important in understanding executive pay levels; the executive of a poorly performing company may seem too highly paid unless considered alongside levels of pay in strongly performing competitors.

MYTH NO. 3: COMPANIES SHOULD NOT PAY FOR TENURE

The economist and Nobel laureate Gary Becker, in formulating the theory of human capital, demonstrated that pay should increase with tenure if "bonding" of the employee to the organisation generates value for the organisation.[6]

Becker distinguished between general and firm-specific human capital. General human capital is transferable across organisations — a professional qualification or evidence of skills that an employee has mastered that would bring value to many potential employers (in the right role). Firm-specific human capital, on the other hand, is learned on the job and is valued only for as long as a person stays with an organisation.

Examples of firm-specific human capital include internal social networks and understanding of company-specific products, protocols, technologies, and systems. Firm-specific human capital is nontransferable — its value falls to zero when an employee exits an organisation.

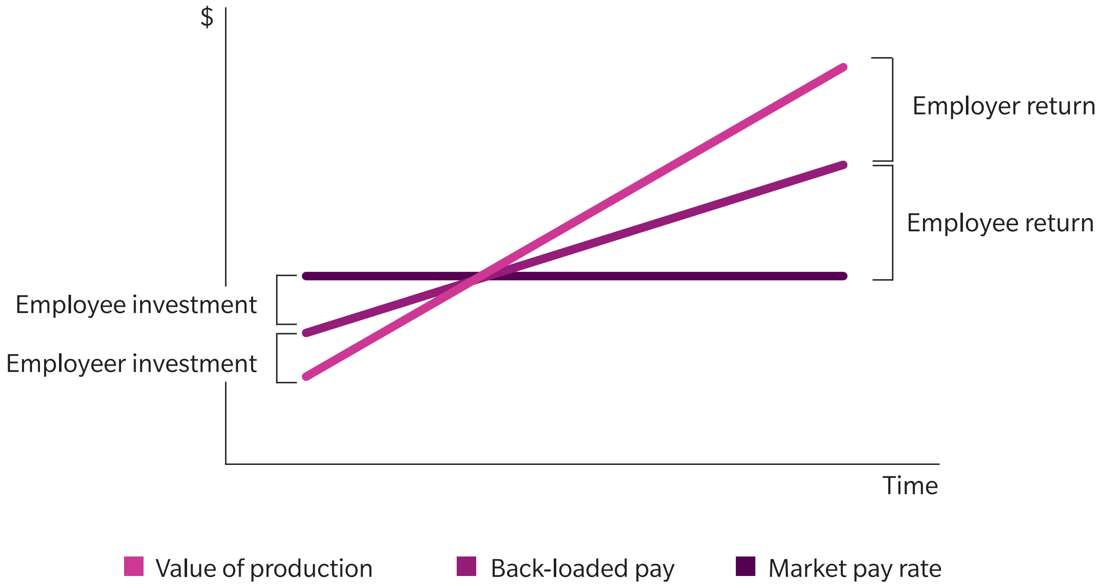
Given that firm-specific human capital is only valuable at the current employer, who should pay for its acquisition? If such learning comes at the expense of immediate productivity, an employer would not pay for it alone, as the company would face lost recompense should the employee leave. An employee would also not pay for it alone, given the threat of dismissal. The solution lies in a split investment and in a split return, which is paid to an employee in the form of increasing pay over the period of tenure, creating a "bond" between the employee and the employer.

Figure 2 depicts how such an investment split might be realised. Early on in tenure, an employee's value to a company that offers firm-specific training will generally be below the "spot market" value — what he or she could make elsewhere. During this period, a firm will pay an employee less than the market value but more than what he or she generates. In other words, both employer and employee make an investment.

The fact that they make this investment means they are inclined to stay together to reap the later benefits when an employee's productivity rises above the "spot market" value.

[6] Becker GS. *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education*, Chicago: University of Chicago Press, 1993 (third revised edition).

Figure 2
Employee vs. Employer Investment Split



At that time, the employer pays less than the value generated by the employee, and the employee is paid more than his or her outside value. Both employer and employee are "bonded" to the relationship by future returns — provided the total returns from the transaction to each exceed what they would have received from a "market rate" exchange over the period.

(In such a scheme, future employee pay, after the expected separation point, would eventually provide for an excess return to the employee, diminishing the return to the employer. This would lead to mandatory retirement — now generally illegal — or other incentives for employees to terminate at a specific point in time. Employees who stay on postretirement would be hired back at lower rates, something that we are seeing companies actively pursue in environments where critical skills are at risk with imminent baby boomer departures.)

In the case of a large financial institution, we were able to match employee-level data on tenure, performance, and payouts (among other factors) to information on branch performance, including market share and revenue, over multiple periods. In running statistical models to ascertain the various factors — human capital and others — that affected results for the branches, it was found that each year of average tenure for the workforce was worth millions. This came about through the greater success of financial services representatives who were well-informed about the bank's products and linked to the relevant personnel to best support customers.

The bank balanced a new emphasis on "up-skilling" against a continued need to support, motivate, and retain its value-generating, seasoned workforce.[7]

What to consider in "paying for tenure":

- Back-load employees' compensation when it is important to "bond" them to the organisation — whether to build firm-specific human capital or limit replacement costs driven by attrition.

[7] Levine B and Nugent K, 2005.

- Strength incentives for employees to be retained through the use of vesting schedules, tournaments, and long-term incentives also strengthen incentives.
- Use caution in market-pricing jobs, as such benchmarks cannot reflect the value of a given employee's (or organisation's) firm-specific human capital.
- Do not ignore performance! If tenure has value, performance will be higher for longer-serving employees.
- Consider carefully whether value is sustainable. Can performance decline after excessive tenure, or might the business needs change?

MYTH NO. 4: STRONGER FINANCIAL INCENTIVES WILL IMPROVE PERFORMANCE

Obviously, this cannot always be right, but in cases where organisations look to incentives as "the performance solution", outcomes often fall short of expectations. Research looked at hundreds of cases of HR programme changes and found that the implementation of new financial incentives had the most inconsistent impact on productivity.[8] More recently, a group of behavioural economists showed in the context of a high-stakes experiment that when tasks were complex, incentive-based rewards actually hurt performance.[9]

(In his 2009 book *Drive*, Dan Pink cites a number of psychological studies over decades that have implied this same outcome, namely, that results can be undermined by explicit incentives.[10] His conclusion was that traditional incentive awards "can extinguish intrinsic motivation, diminish performance, crush creativity, and crowd out good behaviour. They can also … encourage unethical behaviour … and foster short-term thinking.")

Psychological assessments of financial incentives claim that while they may counter adverse selection (the attraction and retention of poor performers) and moral hazard (the potential for employees to shirk their responsibilities), they may also diminish the ethical, altruistic, or simple intrinsic motivations that employees already have for pursuing organisational objectives by signalling a lack of trust, undermining employee autonomy, or creating confusion or stress.[11] In considering the implementation of financial incentives, keep in mind the following:

- How the risks of having financial incentives in place compare with those of not having such incentives. (For example, stronger performers are likely to be motivated by the incentive but weaker performers may become demotivated. Conversely, if no incentive is in place, stronger performers are more likely to be demotivated).

---

[8] Guzzo RA, Jette RD, and Katzell RA. "The Effects of Psychologically Based Intervention Programs on Worker Productivity: A Meta-Analysis," *Personnel Psychology*, Volume 38, Number 2 (1985), pp. 275–291.

[9] Ariely D, Gneezy U, Lowenstein G, and Mazar N. "Large Stakes and Big Mistakes," *Review of Economic Studies*, Volume 76, Number 2 (2009), pp. 451–469.

[10] Pink DH. *Drive: The Surprising Truth About What Motivates Us*, New York: Riverhead Books, 2009.

[11] Pink DH, 2009; and Bowles S. "Policies Designed for Self-Interested Citizens May Undermine 'The Moral Sentiments': Evidence from Economic Experiments," *Science*, Volume 320, Number 5883 (2008), pp. 1605–1609.

- Whether employees are already exhibiting desired behaviours and how this might change with a financial incentive.

- The implied messaging of the programme.

- The extent to which creativity, innovation, long-term focus, and/or collaboration are critical.

MYTH NO. 5: BASE PAY IS NOT A MOTIVATOR

Analyses by Nobel-laureate economists George Akerlof and Janet Yellen demonstrate the validity of so-called efficiency wages — that is, base pay in excess of market rates, for the sake of increased productivity or efficiency.[12]

The idea is that base pay levels above market rates can motivate employees if partnered with the ability to remove employees who are not performing. (Employees who leave are forced to work elsewhere at market rates or to endure a spell of unemployment.)

Efficiency wages should be used when conventional incentives cannot be used — that is, when observing productivity and supervision is expensive (and when productivity, therefore, is hard to monitor). Motivation here is via the continued offer of high-pay employment provided that employment is maintained.

Mercer has seen direct evidence in favour of the existence of efficiency-wage structures. All else being equal, employees working under "stretched" supervisors often have higher levels of base pay. (Mercer often sees the opposite for jobs with incentives in place; these jobs tend to be less complex than those in an efficiency wage structure.)

In summary, consider the following when thinking about base pay:

- When monitoring employees is expensive or difficult, base-pay premiums can provide incentives.

- Supervision (for example, spans of control and supervisory levels) can be optimised when employee compensation is also considered because higher levels of base pay may result in reduced levels of supervision being needed.

CONCLUSION

What the cited research and our case examples show is that these five common myths — while often grounded in a partial truth or underlying organisational perception (such as, "We have too many highly paid layabouts.") — tend to be overstated and are too often relied on as a knee-jerk basis for action. In the earlier cited case of the child care centre, the late pickup backlash (following the imposition of fines for that very activity) was difficult to predict. It is not easy to avoid such mistakes, and the imperative for reward leaders is to carefully think through whether changes can potentially generate a gain, considering both the intent and the potential side effects.

Ultimately, it is important to test whether programmes are delivering the desired results, in order to be ready to respond quickly and make changes when needed. This may mean

[12] Akerlof GA and Yellin JL (eds). *Efficiency Wage Models of the Labor Market*, Cambridge: Cambridge University Press, 1986.

taking the time to pilot new programmes in small units — a step that is not often considered. If there is not time to run such tests, monitor the programmes and rely on modern statistical techniques to gauge programme impact in the organisation and to refine parameters. Such methods can even serve to evaluate how effectively your various programmes mesh. If the incentives do not work (in concert with pay levels, supervision, performance management, and leadership development programmes), perhaps the principles leading to the plan design are based on one of these five myths.

ABOUT THE AUTHORS

Brian Levine is Mercer's Workforce Analytics and Planning leader for North America. Based in New York, he can be reached at +1 212 345 4194 or brian.levine@mercer.com.

For more information on performance management and organisation performance in Europe, please contact:

Sue Filmer at +44 20 7178 5546 or sue.filmer@mercer.com
Daniel Hibbert at +44 20 7178 5520 or daniel.hibbert@mercer.com