5 | 2014
workspan
The Magazine of WorldatWork©

Pay-for-Performance Models: Alignment vs. Dysfunction

Is enough emphasis being put on pay for performance in this market?

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As a fact of organizational life, pay for performance has been troubling employers and employees, it seems, for as long as anyone can remember. But the question has become, are they troubled enough?

Indeed, the conventional thinking is that pay for performance essentially means various forms of variable pay. But research and client work by the authors' company show that it's a much more nuanced concept than most organizations realize, with short shrift given to alternative models of pay for performance that may yield better results.

Fortunately, the profile of pay for performance has never been higher than it is now, with every realm from academia to mass media weighing in on it. That's no accident, for in the wake of the recent financial crisis, many companies have found themselves facing cutbacks in compensation expenses. With fewer dollars to spread around the company, there has been a greater emphasis on differentiation of performance ratings and pay, and even more emphasis on variable compensation.

All the while, experts debate whether financial incentives are effective drivers of business success, boards wrestle with the populist notion of giving all stakeholders some say on pay for executive compensation, and blogs and newsfeeds are never short of opinions and statistics that argue how counterproductive and disliked performance reviews tend to be.

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In his 2009 book, "Drive: The Surprising Truth About What Motivates Us," Daniel Pink argues against old models of employee motivation driven by rewards and fear, and focused on money, as opposed to intrinsic motivation, such as mastery of work and a sense of purpose.

And as if to underscore just how hot the issue has become, a recent PowerPoint presentation by top management of Netflix went viral, with more than 5 million views on the Internet, according to a *Harvard Business Review* story. The deck detailed the company's unconventional talent management and performance strategies, which include top-of-market pay, a resounding emphasis on employee freedom, and the abolition of formal vacation and performance review policies.

Continuing Struggle

Simply, organizations continue to struggle with pay for performance, and it's not getting any easier. If anything, it's more complicated, given an uncertain global economy that has meant everything from reduced pay-increase budgets and incentive pools to increased shareholder activism, along with emerging government regulations. That so many of the performance measures used in typical variable pay plans are driven by systematic market and industry fluctuations over which employees have little control, rather than by actual worker performance, further complicates the design of effective incentive compensation.

While human resources and total rewards leaders have always sought best practices in pay for performance, the most prevalent approach has been and continues to be the variable pay model, relying on increasingly differentiated combinations of year-to-year base pay increases and incentive payouts, all strictly aligned to individual performance for variable pay — in addition to other measures.

But most organizations are not satisfied with their pay-for-performance programs, and there's a general sense of dysfunction. Results of the "2013 Pay for Performance Survey" by the authors' company shows evidence of such. The survey queried 570 U.S. and Canadian organizations.

Arguably, the prevailing variable pay model — reported by more than 85 percent of participating organizations as the reward model most closely linked to performance — reflects an overused and unnecessarily narrow view of pay for performance, especially because there are multiple models that can vary the mechanism through which higher financial rewards are made to better performers. The key to success is aligning the right model to each organizational circumstance.

Clearly, organizations are looking for better alignment. The 2013 survey results showed that 55 percent of participants focus "to a great extent" on pay for performance for executive, managerial and sales employees, while all but 5 percent are focusing on it "to some extent." But, more telling, 63 percent of them are working to increase differentiation of pay based on performance — mainly through guidelines for ratings distribution and next-level manager review — while only 2 percent are working to reduce that differentiation.

Yet nearly half of the organizations surveyed believe that pay-for-performance programs "need work." Survey respondents embrace the concept of pay for performance, but not many said they have got the concept working right in their organizations.

Multiple Models

Attracting and retaining the right talent top the list of priority outcomes expected of pay-for-performance programs, followed closely by "motivating employees to focus on the right things and perform at higher levels." To do so, organizations must optimize their rewards programs — and seriously consider whether the prevalent variable pay model, with its emphasis on pay differentiation and links of payouts to contemporaneous performance, is the right one.

Too many organizations have lost sight of the fact that there is more than one way to pay for performance. Following are three other pay-for-performance models that organizations should consider deploying as alternatives to or in combination with traditional variable pay models (for the enterprise or for different employee segments):

- In a promotion-focused or "tournament model," pay varies significantly from one career level to the next, with less emphasis on differentiation based on performance among employees in the same level. In this model, competition for advancement, rather than the size of the base pay increase or annual incentive, is what motivates employees to perform well. The best performers earn more via promotions based on relative performance evaluation. About 14 percent of those in the 2013 survey reported using this type of model.
- In a membership or "efficiency wage model," overall pay (and benefit) levels are targeted above

the market median and employees must perform to high standards to stay on with the organization. In this model, the desire to keep a high-value position is what delivers incentives to perform well. Again, about 14 percent of those in the 2013 survey said they use this model to attract and retain high-performing talent and motivate performance.

- In a service or "bonding model," a trajectory of planned increases shifts pay from early to later in the career, once performance is credibly demonstrated. This model also locks in employees over the long haul, preserving firm-specific knowledge key to productivity while enforcing performance minimums to stay with the organization. Only 7 percent of those in the 2013 survey reported using this type of model.

As observed, about half of the surveyed organizations indicated their pay-for-performance programs need improvement; one-third of them were anticipating or planning revisions to their programs.

Misalignment is a likely reason for this, because many of those relying on traditional incentive compensation are more likely to cite their performance measurements as "noisy" or influenced by other factors that make actual performance levels difficult to interpret. They may want to consider alternatives that are less dependent on the precision of absolute performance measures and require less frequent monitoring — for example, the tournament model that relies solely on rankings, or a membership model that stipulates a performance threshold.

While conclusions are limited because of the self-reported nature of the data, the survey supports that using the right model in the right context can enhance effectiveness of pay-for-performance programs. Respondents were classified as using a particular model when they said they "strongly agreed" that the approach was a primary mechanism for managing pay for performance.

Those respondents focused on the membership model — high pay relative to market — report the highest levels of effectiveness. The model is most often used by employers who say they are trying to balance "build" and "buy" talent strategies — that is, to build or develop from within, or to buy talent on the open market — to support the attraction and retention of high performers.

Surveyed companies using the tournament or promotion-based model judged their plans as more effective than companies relying on more traditional incentive compensation models. The tournament model is associated with build-from-within talent cultures, but, given the model's reliance on relative ranking (and, therefore, competition), it is less likely to be appropriate for employers reporting a high need for collaboration in their organizations. While more research is needed on this point, the survey supports the point that organizations fare better in managing pay for performance when their models are aligned with their company culture and attraction/retention/engagement strategies, as well as with their measurement approaches.

Model Segmentation

Slightly more than one-third (36 percent) of survey participants reported using multiple pay-for-performance models, but it's not clear to what extent this reflects their use of a combination of models versus using different models for different employee segments, such as business units, job families or multinational locations.

The complex question of how different models may be used optimally for different workforce segments is worthy of careful, expert exploration. And while such segmentation only makes sense, it's vital to balance any segmentation strategy against the need for consistency in complex, global organizations, especially those with high rates of employee mobility.

Indeed, workforce capability and motivation are two areas that companies can focus on — not only to drive performance but to solve the pay-for-performance challenges raised by an all-too-prevalent variable pay model and a lack of clarity, or courage, when it comes to other models and segmentation strategies that may be better aligned to the organization. "Big data" analytics for human resources can be leveraged to track the effectiveness of these approaches, and ensure that they drive retention and performance.

Ultimately, companies must invest more time in identifying talent needs and strategies, critical talent and factors that influence employee behaviors. It's a matter of being open to alternative models, assessing fit to context, monitoring effectiveness and optimizing accordingly. Despite all the noise and negativism that surround pay for performance in today's wired world, it's a riddle that each organization must solve in its own way. ws

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