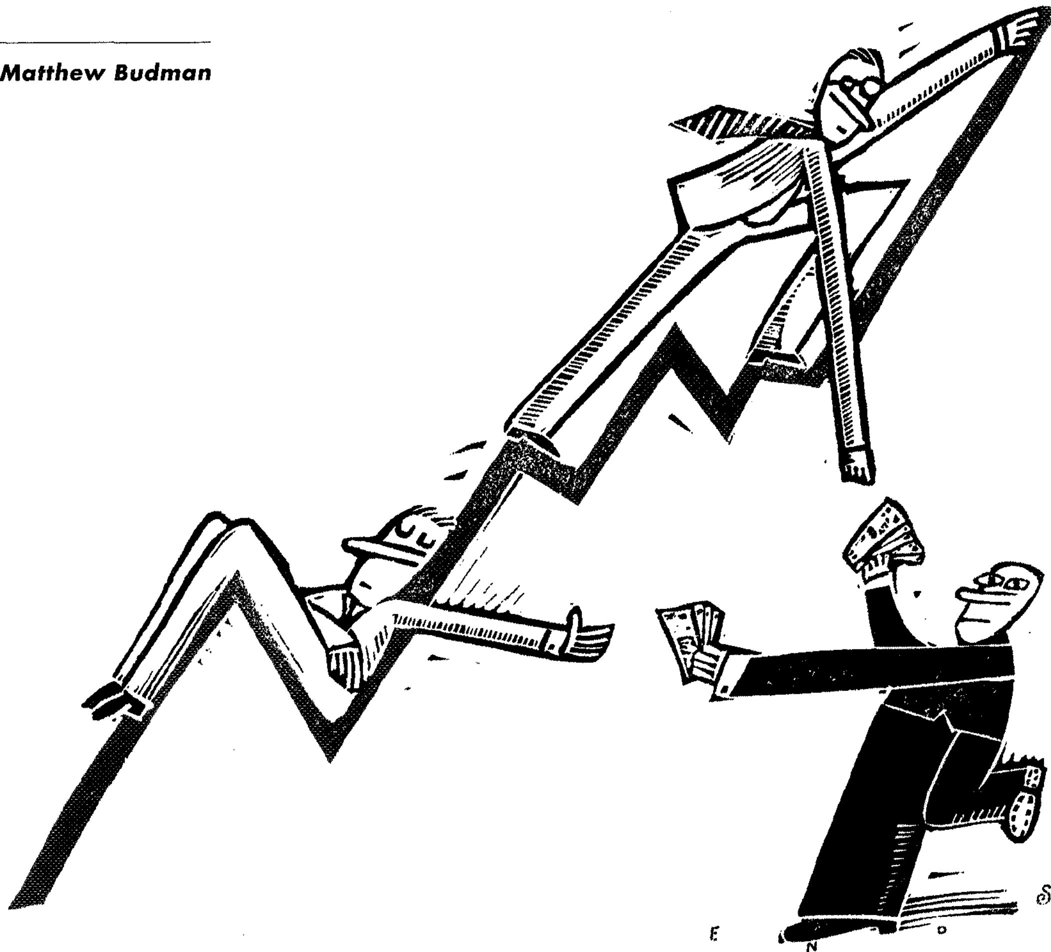
By Matthew Budman



RANDALL ENOS

Is There Merit in Merit Pay?

Yes, but only if you consider doing good by not doing worse.

Your managers hate it. Your employees hate it. By any measure, it doesn't do what it's supposed to do. In fact, no one's quite sure *what* it's supposed to do.

It's the annual performance-review charade, in which, typically, managers and managed play an uncomfortable, closed-door game that no one wins. The end of the game comes with the announcement of a number. The number may be 3, 4, 5, or even 6.

That number, of course, represents the annual merit-pay salary increase. Your manager has spent hours agonizing over that 3, 4, 5, or 6 percent raise, weighing the worker's performance against her colleagues', and against the overall merit-pay budget. That budget is probably a small one, without much flexibility. No one has explained to the manager or the worker what the increase is intended to signify or produce.

If your company is like most others, this is how it's done. More than likely, the top worker ends up with a 5 percent or 6 percent raise; the worst performer leaves his boss's office with a 3 percent increase. This works out to a difference of some $10 to $20 a week, which, in case you're wondering, is unlikely to inspire the laggard to start arriving early and leaving late, to scale the heights of high performance, in hopes of securing his own 5 percent raise a year later.

But is merit pay even *supposed* to motivate workers? Perhaps not. "*Nobody* believes the traditional merit-pay systems motivate people," says Peter LeBlanc, Sibson & Co. national director, organization performance

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and rewards practice.

So what is it for? Well, most of the time, it serves as a simple guaranteed cost-of-living increase. That's how your employees see it: A Watson Wyatt Worldwide survey last fall found that 95 percent of companies say their workers think of merit pay as an entitlement. Whether the number is 3, 4, 5, or 6 seems almost purely arbitrary.

What Is "Better Work"?

In theory, merit pay *should* work. "What we're doing is showing people what they do on the job and the rewards they receive," says Robert L. Heneman, associate professor of management and HR in Ohio State University's Fisher College of Business and author of *Merit Pay: Linking Pay Increases to Performance Ratings* (Addison-Wesley). "If employees can make a clear link between their work and their rewards, they'll do better work."

But that link is a fragile one. What is "better work," anyway? No one's quite sure. As more work shifts from manufacturing to creativity-based thinking, it becomes more difficult to design quality goals. Performance measures don't translate easily from parts-manufactured-per-hour to ideas-generated-per-financial-quarter. "In most merit-pay plans, the performance measures aren't good ones," Heneman says. "It seems random. People don't know what you're actually rewarding." And the "rewards" usually refer to that 3 percent to 6 percent range.

Here's the question, then: *If it's common knowledge that the current pay system doesn't work, why is almost everyone sticking with it?*

True, there's no ideal alternative. "Merit pay would have been gone a long time ago if there were a better system," LeBlanc says. "But there isn't another, more-effective system out there."

The Persistence of Merit Pay

The first question that must be asked: Why do companies still rely on merit pay? Well, first, there's the John Wayne factor. "We're still not a collective culture, like, say, Japan," Heneman says. "People believe in individual rewards, and merit pay very much targets the individual."

Then there's the fact that most supervisors and employees see merit pay as an entitlement. "There's an entitlement culture that's grown up in many organizations, and employees have become very accustomed to receiving merit increases, so not receiving them would be like attacking motherhood and the flag," Heneman says.

And there's the research factor. Studies showing merit pay inspiring higher performance aren't easy to find—but then again, neither are studies showing merit pay having *no* effect. Few studies, Heneman says, address merit pay's impact on future performance.

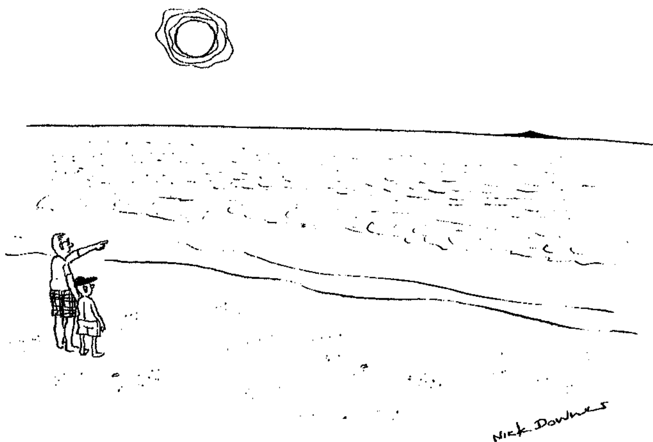
Most significant, though, is that changing a company's pay system is a dramatic step—a step away from something safe and unchallenged to something untested and open to question from all sides. "Some companies don't want to be the first to try anything," says Sandra O'Neal, principal and worldwide employee pay practice leader at Towers Perrin in St. Louis. "And most pay systems cover the entire organization, so if you make a change you're affecting everyone."

Difficult Tradeoffs

Don't blame your managers for your merit-pay program's failure to actually accomplish anything. For several years now, a typical compensation plan provides for an overall 4 percent salary-increase budget, but, naturally, managers don't like to give anyone—even laggards—less than the rate of inflation. "Three-quarters of the 4 percent merit-pay increase is just something you have to do as an employer," LeBlanc says. "Otherwise, people are going to leave." And you do want to remain an employer of choice, right?

"Supervisors have the toughest jobs in America," he continues. "They're trying to lead and influence a small group of people, and a manager is almost helpless in that effort. Everything is controlled by the organization. Job openings, benefits, and time off are controlled by the company. What does he have in his kit? Just the goodwill that a manager tries to create, a positive working relationship. What happens is that a manager who's confronted with a budget of 4 percent is faced with risking that relationship."

Laughing Matters



"And there, just visible on the horizon, is Japan's trade surplus."

His only real solution, LeBlanc says, is to hand out raises that barely distinguish between top and bottom. "That avoids the one outcome the manager can least afford—to piss off acceptably performing workers."

Heneman agrees: "There's little incentive for a manager to give accurate ratings," he says. "If you don't want to create enemies or friends, you just give everyone about the same increase."

Communication and Buy-In

What are the biggest hurdles in changing pay systems? Pound Ridge, N.Y.-based consultant John A. Rubino insists the problem is in implementation: "Most companies just don't know how to do it properly. The background work has to be done—you have to train your managers to the new approach, you have to change the workplace culture, you have to give employees more autonomy," he says.

Training managers isn't an insurmountable task, but changing the corporate culture and building trust are more daunting. "In these precarious times, people tend to see changes in their pay systems as a way to pay them less," says Maureen Scully, assistant professor of industrial relations at MIT's Sloan School of Management. "A lot of people are more concerned with security these days. You have to be careful about what guarantees you're putting in its place."

How do you get employees on your side? Talk to them. "On some days I feel like a communications consultant rather than a pay consultant," O'Neal says. "How employees react to a change is totally dependent on how the information is shared. It could be the whole range of emotions, depending on how you communicate it."

Employee buy-in is crucial to an effective pay system—and to changing a pay system. Convincing workers that change is positive is always difficult, and it's doubly so with regard to compensation. The abandonment of a safe, predictable merit-pay system sets off warning bells with just about every employee.

"People are extremely averse to actions anyone takes to make them do less well than their reference points," says James Rebitzer, Sloan School associate professor of management. "They're much more averse to falling below their reference points than they are happy to be above them."

Measuring Performance

One oft-mentioned reason for merit pay's failure to be true pay-for-performance is the way companies measure performance. "It's almost always the case," says Rebitzer, "that when people's jobs are complicated, you don't have good performance measures. I see it most in professions like health care, where you have physicians struggling with incentives. You can undo some of the crudeness of pay measures by having some subjective performance measures, but subjective measures have problems of their own—they involve a lot of trust and social pressure."

Heneman notes that some organizations are leading the way by measuring *competencies* rather than performance. "Two areas are customer service and teamwork, which some organizations are starting to evaluate," he says. "For teams, they're looking at what it means to be a good team player: showing up to meetings, showing up on time, being prepared, offering constructive criticism, offering ideas. The important thing is to sit down with employees and work out the standards so everyone knows what they are."

Putting employees' pay at risk transforms the role of compensation from carrot to stick, introducing anxiety to the equation.

Pay consultant Patricia Zingheim, co-author with Jay Schuster of *The New Pay: Linking Employee and Organizational Performance* (Lexington), notes that, while many companies have moved toward team-based organization, performance measurements haven't changed much. "The individual performance appraisal is far removed from your business imperatives. You can say you want to reward teamwork, but what you really want to reward is team *results*," she says.

The Bottom Line

Most companies that consider switching to another pay system will likely look first at some sort of variable pay, a catchall term that generally includes all manner of financial incentives, from pay-at-risk to tying employees' compensation to the company's performance. "Variable pay tends to look at the larger business unit, like a department or the whole company," Heneman says.

Would converting to variable pay cost you more? It depends. "Unfortunately," Heneman says, "the rallying cry in business is doing more with less. Merit budgets"—that is, the money on top of basic cost-of-living increases—"have not been particularly large in recent years. You can have the best-designed plan, but if you don't have a meaningful amount of money to distribute, the plan isn't going to work. Organizations that come out with a 2 percent merit budget—what can you do with a 2 percent merit budget? It doesn't matter *what* you're measuring for."

LeBlanc agrees. "Companies keep giving

these 1 percent merit increases," he says. "They don't realize that anything under 3 percent is offensive to people."

If you can't spend more, and your preference is to put more of employees' pay at risk, you must have managers prepared to hand out raises of 0 percent along with those of 8 percent—and prepared to face the consequences: most likely, a quarter of your workforce quitting at performance-appraisal time.

If you can't face that, you need to develop nonmonetary rewards, which aren't as easy as they used to be. While promotions are widely considered the best workplace motivator—all carrot, no stick—there simply aren't the same opportunities today as a generation ago, or even a decade ago.

"Managers in flattened organizations are very aware that the promotional ladder's not there anymore," Scully says. "So now you need to come up with other rewards—comp time, better assignments."

LeBlanc agrees: "Special recognition and treatment—and I'm not talking about trips to Hawaii. Recognition that the work you do is important. That's what people care about," he says. It can't hurt to leaf through one of the dozens of *1,001 Ways to Reward Your Employees* books weighing down bookstore shelves. Thoughtful perks, from plaques and ceremonies of recognition to meetings with the CEO, motivate most workers better than cash awards. Tickets to plays and ballgames are always appreciated and remembered.

If you *can* afford a significant merit-pay budget, by all means, try out monetary incentives—bonuses, one-time cash awards, wide-ranging merit increases—and see if they produce higher performance.

Revise or Replace?

Merit pay may be flawed in concept and is certainly flawed in practice nearly everywhere, but that's not to say it *can't* work. "I think people are right who are saying it doesn't seem to be working most places, but I think it has to do with implementation more than anything else," Heneman says.

Some make the point that, for the bulk of companies—those without finely tuned performance management—merit pay, while not achieving stated objectives, nevertheless does good by not doing worse. "If you're committed to the pay-for-performance goal, merit pay doesn't work, because you're not motivating people to a higher goal. And as a tool to differentiate between people, it's terrible," LeBlanc says. "But even though merit pay has fundamentally failed, it is achieving other objectives. It's a way to retain people and avoid a lot of dissatisfaction around what people earn. Is that so bad? While employees and managers poke at it, saying it isn't real pay-for-performance, it's actually doing good. It's avoiding anarchy. There's no groundswell of dissatisfaction. It's a sedative."

There must be better options than stopgaps and sedatives, right? But the hot one of the moment—variable pay—isn't question-free.

Putting employees' pay (or, more accurately, raises) in jeopardy is highly problematic. It transforms the role of compensation from carrot to stick; it introduces anxiety and even desperation to the equation. "When more pay is at risk, pay becomes a motivator in terms of fear," says Scully. "Pay is a very clumsy tool, and, for a lot of people, using pay as a tool means sharpening it."

And since everyone's competing for money in a limited pool, pay must be distributed on a curve, which promotes unhealthy competition, with the losers' homes, possessions, and marriages threatened. In a conventional merit-pay system, it doesn't matter all that much, since there's only a 2 or 3 percent range between top and bottom, but a program under which a front-line employee who has a bad December can wind up short hundreds or thousands of dollars is dubious, to say the least. (On the other hand, Zingheim says, "There are economic realities. People aren't *owed* that 3 percent.")

The trend of linking workers' pay to the performance of the company or department is similarly suspect. It's one thing for a CEO to shoulder some risk by taking some compensation in the form of stock options, and quite another to mandate that a receptionist give up some paycheck security on the vague hope that the corporation will flourish.

So if merit pay is ineffectual and variable pay is dangerous, what's left? You could, of course, remove pay from your system of rewards altogether. Since most merit-pay plans serve as basic cost-of-living adjustments anyway, why not just hand out COLAs—saving managers time and workers anxiety—and use nonmonetary rewards?

Of course, this is easier to say than to put into practice, and it's unlikely that more than a relative handful of companies will give up a motivational tool, even one as unwieldy as compensation. James Rebitzer is probably correct to be pessimistic about anyone developing the perfect pay system anytime soon. "Organizations go through cycles. The systems break down, and then they innovate again," he says.

"Subjective evaluations begin to break down, and problems are exacerbated by more pay-at-risk. You end up devolving back to the same 4 percent annual raise. Then you want to get people's attention and do something dramatic. Companies keep cycling around, and maybe the cycling is as important as anything they end up with." ■