Piloting Pay for Performance

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August 2006, Published on WorldatWork Website

CEOs are struggling to improve mileage from major opportunity expenditures. And what organizations spend on pay and rewards often is one of the major costs of running an organization — for-profit and not-for-profit alike. In many instances, pay and rewards constitute the largest cost. As an organizational leader or HR professional, it's essential to manage pay and reward costs to add value to organizational goals. But paying for performance in real terms is not easy — it's easier to avoid basing pay on performance or addressing performance issues.

And while nearly every organization says it pays for performance, many would admit to not doing it very well. For example, if an organization ranks employees in terms of value added from top to bottom, how many actually pay the most valuable employees the most and the least valuable employees the least? More likely, rank order has more to do with service, tenure, management vs. non-management or something else not directly related to the value people bring. How can total rewards professionals move incrementally to paying for performance in a positive fashion?

What Does Paying for Performance Mean?
Paying for performance means:

- Meeting pre-set goals or measures meaningfully will influence pay and rewards, and everyone knows and accepts this.
- More pay and other rewards in significant amounts go to the most skilled, best performers. The "superkeepers" get much more of what is available because they have fresh skills the organization needs and are able to translate these skills into measurable goal performance.
- The differences in skill application and performance that are defined in the performance management process should be matched by differences in pay and rewards that are awarded. The size of the award should basically fit the performance.
- Employees and managers understand why they receive the rewards they do. The management of pay and rewards should be a "no surprises" affair. The reward should match the message communicated about where the individual fits in the overall performance scheme of things.
- Managers must be responsible for determining, granting and communicating rewards. They must not say, "I would have done something different, but HR wouldn't let me." One of the entrance

requirements to management must be the willingness to coach and provide feedback — and tell the truth about adding value.

These are difficult and challenging requirements. The problem, professing pay for performance but not following through, is a huge workforce trust issue for organizations and CEOs. Organizations that truly have a reputation for paying for performance have the best chance to attract and retain both employees and managers who are willing to have their performance judged and rewarded, along with those who are willing and able to judge and reward performance.

Moving to pay for performance requires a worthwhile business proposition. While accomplishing at least one of the aforementioned requirements is essential, meeting as many of these as possible improves the probability of getting the most from dollars spent on pay and rewards. A true pay-for-performance communication would tie all five elements into something like:

> *Our organization pays for performance by creating understanding and responsibility throughout the workforce and translating or cascading organizational goals into objectives, skill needs and behaviors that employees can influence. This is part of our total rewards strategy. We use variable pay to focus on goal performance because results can vary from year to year. Also, we use base pay for the increasing value employees are expected to add over their careers. Base pay is determined as a result of employees acquiring and applying critical skills and competencies to their work to produce results.*

Managers who know their employees' skills and goal performance are accountable for managing this process. The performance management process does not focus on "forms," but rather on constant feedback, coaching, communications and mentoring. Paying for performance in the total rewards sense involves cascading goals, management accountability, paying for value added, and performance management that integrates feedback, coaching and communication.

The Challenge

All employees are interested in changes to pay and rewards because they represent modifications to the status quo. There are many reasons companies hesitate to make the change:

- Typically, companies are unwilling or unable to measure and communicate performance and skill differences. It is easier to pay everyone the same than to pay people for the value they add. Once poor pay and rewards habits are formed, they are hard to change.

- Organizations have scarce funds for pay and rewards. These funds often are intended to serve multiple purposes that taint the goal of paying for performance.
- An organization's pay and reward infrastructure isn't geared to pay for skill acquisition and application or performance against concrete goals. Instead, the infrastructure is more geared to paying for how long employees are in jobs and it defines work in terms of inflexible job descriptions rather than skill and performance.

Use Facts to Support Pay for Performance

A search of current literature suggests that the basis for justifying positive change (in the form of pay for performance) to organizational leaders can be summarized as follows:

- **Cascading Goals.** Employees who understand their goals and the business context of their goals will be more likely to achieve these goals than those who don't. And if goals cascade from organizational goals, performance will more likely add value to the business.
- **Variable Pay/Incentives.** Well-designed variable pay returns four times the cost in terms of outcomes. Even imperfect variable pay plans return twice what they cost the organization in terms of value to the business. Small teams that base team-member pay on team goals are more likely to achieve goals than teams that use individual pay only.
- **Paying for Added Value.** Organizations that really pay for performance are more likely to attract, engage and retain employees who want to be paid for needed skill and successful performance. Managers who pay for performance will be most successful with employees who trust the manager to fairly reward their performance through pay.
- **Performance Management.** No evidence suggests that merely changing the forms and paperwork used for performance appraisals will change the effectiveness of the process. However, employees are more likely to view the performance process as positive and helpful when feedback, coaching, performance planning and regular communication are the focus.
- **Management Accountability.** Managers who are responsible for managing their pay and reward budgets are more likely to accurately communicate with employees about their meaning in terms of skill and performance of rewards granted. Employees trust managers who tell the truth about pay more than managers who try to blame the amount of money they receive on others.

This information, plus the experience of comparable organizations with these solutions, needs to be customized to specific cultures and business strategies. However, the case is strong and the need is great.

How to Pilot Pay for Performance

A total change to pay for performance is best if an organization's leadership is committed to making the program work and there is understanding that the change may create "noise" in the organization if the existing culture has been focused on tenure and entitlement rather than performance.

Rather than risk a failure, it is perhaps wise to conduct a "trial run" to determine whether pay for performance fits. Until leadership can prove to the workforce that it is serious about paying for performance, it is best to take small steps, show business value, prove that paying for performance is better than not, and then move forward with confidence and assurance.

Piloting is a slower way to implement pay for performance, but if major and complete changes can't be made, small changes can be tested. Incremental change provides an alternative to the status quo.

Short-Term Actions

There are five actions that will quicken an organization's opportunity to determine whether pay for performance will work:

- **Cascading Goals.** Test cascading goals to ensure the measures used add value to organizational goals. Translate the company's strategic and operational goals into measures and objectives that employees in some segment of the organization can influence.
- **Variable Pay.** Conduct a trial run for variable pay. Variable pay does not fold into base pay and must be re-earned from performance period to performance period. Pick cascading goals and design a variable pay plan in one organizational unit.
- **Pay for Value Added.** For a single organizational unit (or two), implement a plan to pay employees as they obtain and apply the key skills that the organization needs over time. Abandon paying for jobs and pay for value. Identify needed skills and training in skill acquisition, and measure the employee's ability to apply these skills to get needed results.
- **Performance Management.** Modify the current performance management solution to emphasize the dialog between manager and employee. Train a group of willing managers to provide feedback on performance, coach and help prepare development plans to emphasize key areas of performance improvement opportunity.
- **Management Accountability.** Train managers in one or more organizational units to be accountable for managing the pay and reward process for their employees. Managers should be accountable for a budget that they manage throughout the year, along with being responsible for determining who gets what, then explaining it to employees directly.

These actions don't need to be conducted in different organizational units, as the ultimate goal is to implement all of these practices in every part of the company. These pilot steps become "contagious" by demonstrating that there is a better way to manage the pay and reward process. Changing "the way it's always been done" is important because most organizations pay for things other than performance or needed skills.

The Case for Performance Pay

Piloting performance pay provides the chance to showcase major directional change before implementing it more broadly. A logical business case coupled with a pilot that is championed by an organizational leader makes experimentation — and directional change — more acceptable in some organizations. Of course, the risk is that, even if successful, the experiment will not be generalized more broadly. However, a pilot does provide an alternative worth considering and, in many organizations, any kind of move in this direction is a welcome change.