

NewRules: Paying for Performance

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For all of the energy put into paying for performance, there aren't many companies that are doing it well. In fact, according to the June 15, 2004, *Wall Street Journal*, "About 83 percent of companies with some type of pay-for-performance program say the approach is only somewhat successful, or not working at all."

Part two of this article explores five more rules to help companies pay for performance.

6. Replace the term "target incentive" with the term "entitlement."

Companies often are dismayed with employees' "entitlement mentality," but entitlement is merely an expectation created by promises or past practices. And unfortunately, the company is often to blame for creating those expectations.

One of the ways organizations foster the entitlement mentality is through the use of the target-incentive concept. The WorldatWork Glossary states that a target-incentive payout is: "What the employee ought to earn on average, given satisfactory performance." Most employees who haven't committed a felony at work would probably view themselves as "satisfactory" performers, so it is quite likely that if a worker doesn't receive a target payout, there's going to be some grumbling.

Base pay should compensate for base-performance expectations and incentive pay should compensate for performance above expectations. Incentives are tools

to motivate performance that would not occur in their absence.

Anytime compensation professionals communicate an incentive target to employees, they create an entitlement around that target. In fact, the target becomes the payout floor, and the only real variable pay is the amount between target and maximum. It is difficult to pay for performance within this reasonably tight range.

7. Performance is defined for every employee.

If a company intends to pay for performance, then it must define what average and superior performance look like. *Random House Dictionary* defines "performance" as "the act of executing work." Therefore, defining performance is not just about identifying the correct metrics and setting goals around those metrics. Defining performance involves the following three primary elements:

- Recognizing the competencies that create success in the position
- Detailing the work practices and processes that contribute to success
- Identifying performance expectations and properly measuring the success of the individual's work effort.

In a 20-year research project, The Gallup Study on Workplace Satisfaction, "Knowing what is expected of one" was the top factor in motivating employees enough to make their employers successful, according to the Oct. 15, 2005, issue of *Business and Legal Reports*.

QUICK LOOK

- ➔ One of the ways organizations foster the entitlement mentality is through the use of the target-incentive concept.
- ➔ If all companies have the same pay philosophy, then compensation will inevitably fail to differentiate an individual company or attract anyone to it.
- ➔ Perhaps part of the reason that companies have no money to differentiate performance throughout most of the organization is that they spend so much money trying to pay for performance at the top.

If company leaders cannot define levels of performance for a position, then they have not properly examined the need for this position and the role it plays in the company's success. All jobs can be done well, and all jobs can be done poorly. Part of pay for performance is defining and communicating the difference.

8. Compensation philosophy statements cannot use the words "attract, retain, develop, motivate" or "pay at market median."

There is nothing wrong with these words that have found their way into the pay philosophies of thousands of organizations, except that they are overused and empty objectives with no strategy behind them. Their use is as mindless as slapping an American flag magnet on the family car and feeling like a patriot.

The 2003 Survey of Compensation Policies and Practices, by WorldatWork, Dow Scott, Ph.D., and Hay Group, found that 81 percent of companies were targeting base-pay levels between the 40th and 60th percentiles of market. If all

PART TWO

companies have the same pay philosophy, compensation will inevitably fail to differentiate an individual company or attract anyone to it. In order to pay for performance, the compensation philosophy must define what pay is, and more importantly, what performance is. A major steel producer offers a pay philosophy that states, “We will hire five people to do the work of 10 and pay them like seven.” This philosophy is fresh, vibrant and communicates an above-market pay practice closely tied to demanding performance standards.

A compensation philosophy will have minimal value unless it differentiates one company’s compensation practices from the practices of others. Instead, companies may be better off with an attraction philosophy, retention philosophy or development philosophy that could identify the role of pay policy within a broader array of tools, for example, to attract employees.

9. Executive pay should be capped at a multiple of average worker pay.

Many organizations report that they cannot pay for performance with a 3-percent to 4-percent merit-increase budget, but then they turn around and deliver million-dollar bonuses to the executive team. Perhaps part of the reason that companies have no money to differentiate performance throughout most of the organization is that they spend so much money trying to pay for performance at the top.

According to the April 18, 2001, *Business Week* article, “Spreading the

Yankee Way of Pay,” the average CEO of a major corporation made 42 times the average hourly worker’s pay in 1980. By 1990, that number had almost doubled to 85 times the average hourly worker’s pay. In 2000, the average CEO salary reached an unbelievable 531 times that of the average worker. Is this because the CEO’s contribution levels have grown exponentially over the years? Are CEOs today that much more valuable than their 1980 counterparts?

There are some CEO superstars in corporate America that deserve to be handsomely rewarded (for example, Steve Jobs, Howard Schultz and Bill Gates). However, do compensation professionals really believe that the average CEO is contributing the same as 531 average workers? And if so, does that mean that Japan’s average worker is contributing 50 times more than the average U.S. worker, or that the average U.S.

CEO is contributing 50 times more than the average Japanese CEO? (See Figure 1 on page 46.)

A pay-for-performance culture starts at the top, but it doesn’t end at the top. It must permeate the entire organization. Total rewards should maintain a balance between what the executives contribute to the organization and what the average employees contribute. Sharing the wealth is a healthy team approach that properly values the contribution of every employee, and can give every employee a role and a stake in the success of the organization.

FIGURE 1: CEO PAY VERSUS AVERAGE EMPLOYEE PAY

Country	CEO Compensation as a Multiple of Average Employee Compensation
U.S.	531
Brazil	57
Venezuela	54
Mexico	45
Britain	25
Australia	22
Canada	21
Italy	19
Spain	18
France	16
Sweden	14
Germany	11
Japan	10

Source: *Business Week Magazine*

10. Pay for performance is not synonymous with pay for individual performance.

Somewhere along the way, paying for performance came to mean paying for individual performance. Current incentive design principles focus primarily on the individual and the individual's span of control. Simplistically, a job is viewed as having individual impact, department impact, division impact, companywide impact or some combination of these. The problem with this approach is that it maximizes individual performance, while not necessarily maximizing company performance. Maximizing company performance is not achieved by getting every employee to perfectly perform the activities outlined in their job descriptions. It is achieved by getting every employee to do all he or she can to contribute to the success of the business.

Think of a single, successful idea. An idea may be generated by one employee, but others will be involved in researching the application and determining the feasibility of the idea in the workplace. Still others may be involved in prioritizing the idea in light of all of the other ideas that could be implemented. If the idea is implemented, still others will be involved in communicating the idea and

training employees on a new or better work practice or technique. And finally, to make the idea a success, every employee must embrace the change that the idea represents, and shed his or her old ways in favor of a new way. Many HR professionals are quick to give credit to the most visible affiliates of success, but rarely do they recognize the complete cast that contributes to success.

The primary issue that many organizations have with broad-based incentives, like gainsharing or profit sharing, is that they fail to pay for individual performance. This is a legitimate concern. However, most companies already attempt to recognize individual performance with merit increases, promotions, special assignments, training, etc. Most companies do not have a vehicle to reward the successful efforts of the entire workforce. According to the Center for Creative Leadership, research shows that 75 percent of change initiatives fail. Contributing to this rate is a failure to engage the entire workforce in the change process by recognizing the role, large or small, that every employee has in success. Broad-based incentives can be an insurance policy against the failure of change initiatives by providing all employees with an interest in the success of the initiative. In allocating annual rewards, there should be broad-based rewards for successful company performance, and individual rewards for growth in skills, competencies and responsibilities, and for exceeding expectations.

A New Way of Thinking

Pay for performance comes in two flavors, pay for individual performance and pay for company performance. The first should direct employees on how to maximize their contribution to the company, and the second should share the company's success with all employees.

Following the 10 rules outlined in parts one and two of this article will help

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compensation and HR professionals pay for performance by ensuring that pay practices are fair and balanced, that pay is understood as an ongoing investment in people and that every employee understands the value of his or her performance. **WS**

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