# Questioning the Power of Money

## The link between pay and performance might not be as strong as you think.

By Shonna Waters

As more HR leaders opt to scrap annual performance appraisals, many find themselves wondering how they will tie pay to performance. A better question might be whether they should link the two at all. As it turns out, assumptions about the correlation between pay and performance could be all wrong.

Let's look at some common assumptions underlying pay-for-performance policies. Are they supported by evidence?

IMAGE BY ISTOCK

**Assumption 1: Tying pay to performance is fair to workers.** This idea seems straightforward enough: If one person provides more value to the organization than another, he or she should reap greater rewards. While that principle sounds easy to apply, in practice it isn't. Performance is often very difficult to measure. In more complex jobs, it is typically assessed by evaluating the quality, rather than the quantity, of one's work—which is more subjective to define and assess. In such cases, the relationship between an employee's work and incentive compensation becomes less direct and the concept of performance-based pay gets murky, potentially causing employees to question the fairness of the system.

Transparency and effective communications are critical to employees' perception of fair pay, but your performance management system might be complicating that effort. Some research suggests that a small number of employees are "hyper-performers" who could conceivably be 400 percent more productive than an average worker. However, annual raises are typically between 2 percent and 5 percent, giving you little opportunity to differentiate among employees based on their work quality or output. As a result, managers often have a hard time talking to employees about rewards and the rationale behind them.

**Assumption 2: Paying for performance will motivate employees.** The links between extrinsic rewards, like bonuses, and employee motivation are not always direct. (They aren't always positive, either. External incentives can sometimes decrease internal drive, creativity and performance.) In the best of circumstances, external incentives are most effective in encouraging optimal behavior when they are timely, linked to the organization's goals, clearly defined and measurable, as in some sales situations.

But if the connection between performance and compensation is not clear, as is often the case for knowledge workers, internal motivation becomes a greater driver of performance. That inner drive comes from things like the meaning employees find in their work, their commitment to the organization's mission, autonomy on the job, and relationships with co-workers and customers. So, paying for performance may influence employees less than you would expect.

### A Frank Assessment

What does this mean for your compensation policy? To determine whether pay for performance makes sense in your organization, ask yourself a few questions:

- How confident are you—and your employees—in the performance assessments you use to make compensation decisions?
- How strong is the link between monetary rewards and organizational goals?
- How effective is the connection between an employee's behavior and the resulting reward?

If you don't know the answers, a pay-for-performance system might not be right for your company. At a minimum, if you're in doubt, make sure to evaluate your policies over time, assessing both intended results and possible unintended consequences. If your system doesn't seem fair to employees and doesn't motivate them, it's probably not worth keeping. HR

Shonna Waters is vice president of research at SHRM.