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Tracking the Merit of Merit Pay

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Tracking the Merit of Merit Pay

Pay-for-performance can be a powerful motivating tool when it's used effectively and conscientiously

Merit pay, or pay for performance, is well established in corporate America. Surveys of pay practices indicate that the overwhelming majority of U.S. companies have merit pay programs. Moreover, interest in merit pay is surging, despite the voluminous literature pointing out the difficulty of linking pay to performance in practice. Executives see merit pay as a prescription for improving productivity to meet competitive pressures. Similarly, government officials are promoting increased use of merit pay to enhance individual employee performance and organization effectiveness. The idea that pay increases should reflect differences in performance level apparently seems so logical, the need for such programs is usually accepted as self-evident. Unfortunately, once installed, merit pay programs are seldom audited to determine whether they are achieving the goals for which they were designed. Such unquestioning commitment to merit pay programs could be costly in monetary and/or employee relations terms.

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It is surprising that little serious attention has been given to auditing merit pay programs. Salary increase budgets have averaged over 6.5 percent of base payroll the past three years, and in recent years of high inflation the percentage often has reached double digits. Expenditures of this magnitude need to be closely scrutinized, particularly in labor intensive organizations where the return on salary dollars can be vital.

Merit pay

If you ask salary administrators from 10 companies with merit pay programs to define it, you are likely to get 10 different definitions. Merit plans differ in the definition and measurement of "merit," the strength of the link between pay and performance, the timing of merit increases, and the relationship of merit to seniority, inflation, or other pay criteria. The term "merit pay program" here is used generically to refer to programs in which increases in base pay for specific individuals (excluding increases associated with promotions) are geared to the performance assessment of those individuals for a specified time period. We are not talking about general, across-the-board increases, or any monetary incentive that does not permanently increase the employee's base pay, such as a one-time bonus.

Merit pay plans seldom establish pay increase decisions solely on performance. For example, salary structures are generally not open-ended. A maximum pay level is specified for each position, and progression upward through the pay range is linked to performance until the ceiling is reached. In practice, most organizations pare the size of increases as pay rates move through the top half of the salary range. Thus, both performance level and position in the salary influence "merit" decisions. In effect, merit increases become a function of both performance and job tenure.

Furthermore, many organizations implicitly recognize seniority or inflationary pressures by granting minimum increases to all employees out of their merit budget. Obviously, this practice affects an organization's ability to reflect performance differences in pay increases. The link between pay and performance is weakened, hence the probability of influencing individual performance through merit increases is reduced. This is not to suggest that audits of this type of merit programs are inappropriate or unnecessary. On the contrary, the probability of an ineffective program is higher in such situations, making it even more important for management to evaluate the program.

Merit pay goals

What's the point of merit pay?

The initial answer to this question is straightforward - to motivate high levels of performance. Merit pay functions as a "carrot" to shape the job performance of employees. The assumption is that employees respond to monetary rewards. A primary purpose of any merit pay audit is to test this assumption.

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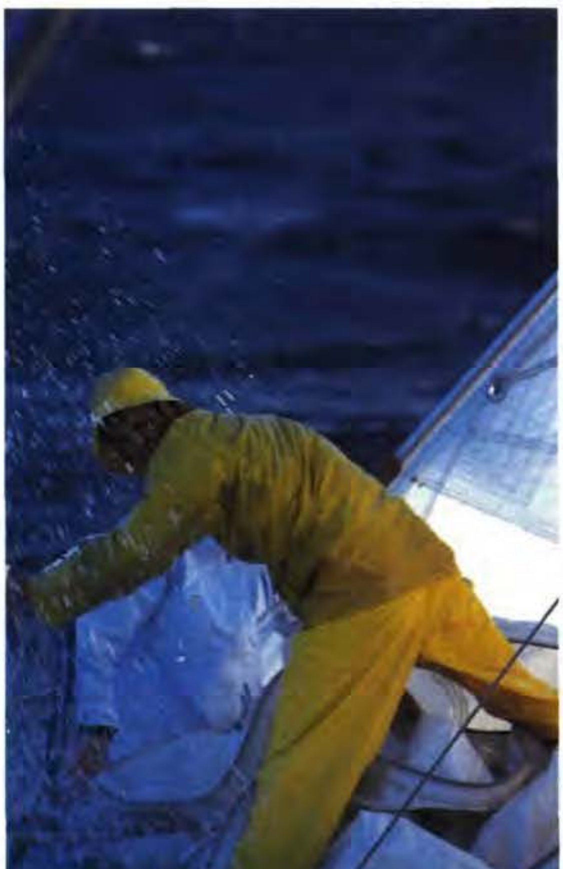

Pay actions send a powerful message to employees. Among other things, they convey displeasure with an employee's performance or signal promotion potential. Hence, merit pay plans provide a means to influence employee's decisions to stay or leave as well as to put forth future effort. By communicating desired messages to valued employees, merit pay can improve the organization's ability to retain top performers. As a result, a second goal of most merit pay programs is to reduce dysfunctional turnover. The extent to which the merit pay program helps achieve this goal should be periodically investigated.

A third goal of pay administration systems is to achieve broad-based acceptance of the merit pay system by employees. If there is widespread disaffection with the pay system, the goals of retaining and motivating employees are not likely to be achieved. Hence, maintaining a reasonable level of satisfaction is the most fundamental goal of merit pay programs. For this reason the extent of employee satisfaction with the system also must be periodically audited.

The goals of influencing employee performance, retaining good employees and providing job satisfaction must be accomplished within legal constraints. Therefore, a fourth goal—legal compliance— applies to all merit pay plans. The merit principle is explicitly recognized in law, but the subjectivity normally involved in appraising individual performance opens merit systems to problems of illegal discrimination under Title VII of the Civil Rights Act. The pattern of performance appraisals and/or merit increases over a period of time could reflect different treatment of women or minority employees. For example, the average increase received by men should not be different from that of women, unless there are legitimate, business-related reasons for the differences. Routine audits of pay patterns provide a tool for identifying possible violations.

Whether a merit pay system influences motivation or retention depends upon employees' perceptions of the system.

Audit strategies

Since the desired outcomes from merit pay plans are both individual (employee behaviors and attitudes) and institutional (retention, compliance, efficiency), a number of different auditing strategies are necessary. Three basic approaches are described here; procedures for their implementation are outlined in the next section.

The starting point for merit pay audits is an analysis of the actual distribution of merit pay increases. Evidence pertaining to the goals of legal compliance, employee retention, and linkage of pay to performance can be developed by analyzing past pay increases. In general, the size of merit increases should be positively related to measures of individual "merit" or performance, negatively related to turnover and unrelated to race, gender and age. Data for these analyses come from organizational records. If personnel information is maintained on computer, this component of the audit is relatively simple and inexpensive.

However, analysis of organizational records reveals nothing about how employees feel about the merit pay program. Hence, the second basic auditing strategy is to track employee attitudes. This can be done most easily via group feedback sessions and/or employee questionnaires. Each method has its advantages. Questionnaires can encourage employee candor, reduce subjectivity in scoring and interpretation, and provide a statistical basis for tracking attitude/opinion changes over time. However, carefully structured group sessions can provide rich detail and intensity not possible in a written survey. For most organizations, a combination of both methods will probably be the most cost effective.

The third component of an auditing strategy focuses on merit pay program characteristics and constraints, rather than outcomes. Numerous factors determine how employees respond to a merit plan. Since this is one topic on which a near consensus exists among practitioners and academics, these "requisites for success" can serve as criteria for assessing merit pay programs.[1] For example, the degree to which merit/performance criteria are specific on the job and accurately measured can be assessed. Deficiencies on either score reduce the likelihood of successful administration. This type of audit complements the first two strategies. By focusing on the program per se, potential determinants of problems evidenced by attitude or merit distributions are more likely to be identified and resolved.

Audit procedures

Merit increase analysis. Analysis of actual merit pay increases can range from simple graphic presentations through sophisticated statistical tests. In all cases, the purpose is to determine whether higher performers actually receive larger merit increases (percentage).

However, the relationship between pay and performance is seldom this simple. Seniority or position in the range could legitimately influence the size of pay increases. Additionally, pay actions could be affected by factors, not included in policy, that are actually illegal (e.g., race, age, gender). The task facing the evaluator(s) is to determine to what degree pay actions are affected by these other factors. The quality of any audit of merit pay distributions depends upon how well this problem is handled.

The problem of multiple criteria for pay increases can be addressed singly or in combination. First, the employee population can be subdivided into categories that are similar with respect to one or more of the factors. For example, if the size of merit increases is also affected by the employee's position in the salary range, the overall distribution of pay increases should be broken down into salary-range categories, (i.e. upper 25 percent, 25 percent above midpoint, 25 percent just below midpoint and the bottom 25 percent of a salary range). A separate analysis can then be conducted for each category. This procedure isolates the effect of performance differences on pay increases. It should be noted here that the relationship between performance level and percent of merit increase can also be described statistically by the correlation coefficient which provides an index of the strength of relationships. In a "pure" merit plan, the coefficient theoretically should approach 1.0. To the degree it is lower, factors other than merit are entering into wage determination decisions.

Second, the effects of various factors can be controlled and estimated statistically using multiple regression. In this approach, the unique effect of various determinants of merit pay can be estimated.[2] For example, the auditor could simultaneously assess the effect of performance, seniority and job tenure on the size of pay increases. Use of regression analysis has been greatly facilitated by the development of numerous applications programs for wage and salary analysis on microcomputers. However, unless the auditors are well-grounded in regression analysis, experts should be consulted regarding preparation and interpretation of the analysis.

The specific analyses of merit pay increases that can or should be conducted in an audit of merit pay practices will depend upon factors such as the goals of the program, the size and diversity of the employee groups, the number of administrative units and the availability of data. In most cases, audits of merit pay increases should include analyses of the following types:

1. The distribution of pay increase percentages within each performance level, i.e. high performers, moderate performers and low performers. If job tenure or position in the salary range also influences the size of increases, subgroup analyses (or multiple regression) will be necessary as noted above.

2. The average pay increase percentage by race and gender within each performance rating category. If seniority or other factors also influence the relative size of pay increases, they must also be included. Multiple regression is particularly useful for this type of check for discrimination.

3. The average pay increase by supervisor within each performance category. This analysis should compare increases given by supervisors within and between organizational units. Inconsistency among

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supervisors in their interpretation and application of merit program guidelines and procedures is a common problem in merit systems. For example, a performance rating score of 4 might result in a 5 percent raise on one department but only 3 percent in another department. If consistency between supervisors in performance ratings is also a problem, the performance rating within departments may need to be standardized before polling them across managers. This may be done manually or with sophisticated statistical techniques, such as Within and Between Analysis of Variance.[3]

4. The distribution of performance levels by range-position. This analysis provides a snapshot of the relationship between salary level and performance level. In general, one would expect to find higher performance levels in the upper reaches of the salary range. The analysis can be further refined by considering seniority, education or any other factor likely to affect the relative level of an employee's pay.

5. The performance rating and merit increase history of promoted employees. If "merit" signals promotability, the ratings of promoted employees should reflect that fact. Promoted employees should be predominantly from the higher performance rating categories.

6. The relationship between merit increases and turnover. The goal of turnover control is being achieved if the leavers are predominantly from the lower end of the performance distribution.

7. The relationship of the current to the previous year's merit increases. Supervisors sometimes operate under a "share the wealth" philosophy and equalize merit increases for their subordinates over a multiple year cycle. Where this is happening the correlation between the increases for any two years will be near zero or negative.

Performance evaluation. The measure of individual "merit" or performance is *the* critical component of any merit system. Merit must be defined in a way that is understood and accepted by the employee, and its measurement must be accurate. First, the ratings often reveal evidence of errors or other deficiencies of raters. For example, a common weakness of merit plans is the unwillingness of supervisors to differentiate among their employees in their appraisals and/or merit pay decisions. The ratings of such supervisors will typically be clustered near the center or top of the rating scale. Furthermore, analysis of merit ratings often reveals rater biases toward various occupations, job levels or types of employees. These problems with individual supervisors' ratings are compounded by the inconsistencies between raters mentioned above. Analyses of the rating distributions of individual raters and breakdowns of ratings to allow comparisons by unit, job level, and occupation are a basic tool for identifying and rectifying these types of errors.

The measure of individual "merit" or performance is the critical component of any merit system.

Second, evidence of the ratings' accuracy can often be obtained by field checks of the rating process. A field check is an actual review of performance appraisal forms and discussion with supervisors to determine the ratings' accuracy of selected employees. The purpose of a field check is to determine whether (a) performance criteria are relevant and complete; (b) employees and supervisors have a common understanding of the criteria and their relative importance; (c) the information available to raters provides a sound basis for judgments of performance, and (d) whether performance reviews are complete and constructive. This audit involves conversations with employees and supervisors and reviews of appraisal documentation relative to other evidence of performance (attendance records, output quantity/quality indicators, etc.). Admittedly this is a judgmental process, but such field audits have the additional advantage of communicating the seriousness of the merit assessment process to all raters.

Employee attitudes. Whether a merit pay system influences motivation or retention depends upon employees' perceptions of the system. At a minimum, monetary recognition must be important to the employee, and he/she must believe that individual performance determines such rewards. Therefore, information about these beliefs, values and feelings is a necessary part of any merit pay audit.

Some of the advantages of using anonymous questionnaires and group feedback methods were noted. Regardless of the method used to collect information, employees' attitudes toward the following aspects of the merit pay program should be obtained:

1. The concept of merit pay. Do employees believe merit pay is a fair way to award pay increases? Do they believe it can be fairly implemented for their occupation or unit?

2. The definition of performance. Do employees believe the performance standards for their job are relevant and complete? Are supervisory expectations clear?

3. The performance measurement procedure. Do employees believe the process used to assess their performance is adequate? Do they trust their supervisor to be fair?

4. The size of merit increases. Is the size of merit pay increases large enough to be motivational? Is the difference in the size of increases between performance levels significant?

5. Linkage to performance. Do employees believe that the size of their pay increase is determined predominantly by their performance? Do they believe that the merit criterion is distinct from seniority and cost of living?

6. The equity of the total system. Is the base rate or pay range for the job viewed as fair relative to that of other jobs in the organization and to market rates?

If questionnaires are used to obtain data on employee attitudes, they should also request personal and organizational data to allow analysis of responses by employee category. For example, employee attitudes toward the pay system could vary by occupation, job level, size of most recent merit increase, performance level, functional unit and tenure on the job. A breakdown of responses into categories of this type provides a basis for more meaningful interpretation of the responses. Information of this type can be requested without compromising the anonymity of employee's responses.

Program characteristics. A successful formula for implementing of merit pay has not yet been developed. However, a number of preconditions and program requirements have been identified and generally accepted.

1. Trust in management. This applies both to management philosophies and goals and to employee perceptions of their particular supervisor. If employee relations environments are shaky, employers are likely to be skeptical of merit programs.

2. Absence of performance constraints. Organizations often have jobs that are eternally controlled, highly interdependent or present other barriers to individual performance. Since merit pay programs are based on individual ability and effort, such constraints prevent effective implementation of the merit principle.

3. Trained supervisors and managers. The quality of performance planning, monitoring, review and feedback is crucial to merit pay programs. Few managers are born with these skills.

4. Good measurement systems. Pay-for-performance systems should be based as much as possible on criteria that are specific to the job and focus on results achieved. Hence, the need for accuracy in measuring performance goes beyond performance appraisals to the information systems providing the data upon which they are based.

5. Ability to pay. The merit portion of the salary increase budget must be large enough to provide significant merit pay increments.

6. Valid job evaluation and externally competitive pay levels.

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Merit pay plans are an attempt to introduce interpersonal equity (based on performance) into pay systems. The effect will be negligible at best if internal job relationships are perceived to be inequitable or rates are not competitive with the market.

7. Distinction between cost of living, seniority and merit. Employees will assume a pay increase is an economic or longevity increase in the absence of strong evidence to the contrary.

8. Open pay policy. A well-conceived and administered merit pay plan is worthless unless the employees clearly understand how the total pay system work.

9. Flexible reward schedule. Perceptions of the linkage between performance and rewards are influenced by the timing as well as the amount of merit increases. It will be more difficult to establish a credible merit pay plan if all employees have the same merit date.

10. Consistent with the prevailing culture. Some employee groups regard performance differentials with suspicion. For example, there are situations where cooperative rather than individual effort might be stressed, or a norm of "taking care of our own" might have developed. In such situations, merit pay could be effective as part of a package of interventions designed to modify the culture, but in the absence of a strategy for change, a merit pay program will be rejected or subverted.

Conclusions

In this paper we have suggested a framework which can be used to evaluate a merit pay program. The recommendations capture some of the technical and analytical capabilities required to conduct such an audit. To the extent that merit pay programs represent both a significant cost factor and a powerful motivational tool, it makes sense to ensure that merit pay is being used effectively and conscientiously. ■

References

1. See, for example, N. B. Winstanley, "Are Merit Increases Really Effective?" *Personnel Administrator*, April, 1982, 37-41.

2. A explanation of multiple regression is beyond the scope of this paper, but examples of its application to pay systems can be found in B.B. Burkhalter et al., "Auditing the Compensation Function for Race and Sex-Based Salary Differences: Further Needed Refinements", *Compensation and Benefits Review*, July-August, 1986, 35-42, and J. F. Sullivan, "Comparble Worth and the Statistical Audit of Pay Programs for Illegal Systemic Discrimination," *Personnel Administrator*, March, 1985, 102-111.

3. See, for example, Dansereau, F., Alutto, J. A., and Yammarionh, F. J., *Theory Testing in Organizational Behavior: The Variant Approach*. New Jersey: Prentice-Hall, 1984.