The Link Between Pay and Performance

Peter Reilly, Associate Director, IES

Introduction

This is a short note examining the relationship between performance and remuneration. We have concentrated on the link at individual (rather than group or corporate) level and we have focused on pay, not any other forms of reward. Finally, we have not looked specifically at the different techniques for relating performance to pay. We have produced separate papers on team-based pay, skills-based pay and competency-based pay, all of which are on the IES website.

We look first at the theoretical underpinnings to motivation and reward before turning to the relationship between pay and motivation. We conclude with a look at its practical application and the implications of these findings.

The theory on motivation

The theoretical starting point with respect to human motivation and work is sometimes taken to be that of reinforcement. This theory suggested that behaviour could be encouraged through the use of rewards and praise and, to a lesser extent, discouraged through punishments. People will experience these outcomes and modify their behaviour accordingly. In the eyes of a behaviourist like Skinner, learning only takes place through external positive and negative reinforcement. These ideas were applied by Taylor and the Scientific Management school. Taylor thought money was the sole motivator for workers to perform. He, for example, advocated piece rate payments as a means of controlling behaviour and orienting it to management requirements. One challenge to this thinking was that it is not clear whether it is past reinforcements that affect behaviour or the expectation of future reinforcements that is key. Another challenge was that the Taylorist perspective was not only economic, but also employer-centred. It did not consider how employees viewed the employment relationship.

In contrast, the expectancy and goal-setting theories put an emphasis on cognition, *ie* the thought processes people go through as they decide to participate and perform in the workplace. Goal theorists pursued this point by saying that future goals (or 'anticipated outcomes', 'desired future state' or 'expected reinforcement') can be used to influence behaviour and motivation. The mere existence of goals can lead people to behave in ways that mean that they will reach their goals.

Latham and Locke demonstrated the value of specific and relevant goals in a study of timber workers in North America. An important finding of their work was that the lumberjacks were motivated by the setting of goals and feedback on performance, without any financial reward for goal achievement being provided. They argued that this was the case because the workers trusted the management and saw the goals as reasonable — they had the means to meet them. These theories, even though they were criticised as being more of a 'technique' than an actual theory, were influential in the MBO (management by objectives) approach that was popular during the 1970s. This emphasised that meeting objectives was the key, not how the objectives were achieved. It stemmed from research that suggested giving employees latitude in how they worked towards their goals was more motivating than determining the process for them.

However, goal theory was refined in a number of ways through expectancy theory. Porter and Lawler, building on earlier work by Vroom, for example, made the important point that motivation will only come if outcomes have psychological value (or 'valence') for people. Effort would be made where people expected to be rewarded for it.

Another strand of social psychology took issue with Skinner's theories, and that came from the 'needs' theorists. Maslow is the best known advocate of this approach. His view was that there are various levels of human needs, both physiological and psychological. People have to satisfy basic (physiological) needs before being motivated by higher level psychological needs. Hertzberg picked up this notion, but refined it. He thought that the determinants of job satisfaction were different to those leading to job dissatisfaction. Negatively changing the determinants of job satisfaction would mean less or no job satisfaction: it would not produce dissatisfaction. Relevant to the role of pay, Hertzberg talked of reward being a 'hygiene factor' or a 'dissatisfaction avoidance' mechanism, in addition to working conditions and relationships with managers. In contrast, such things as the job itself, recognition, a sense of achievement, responsibility and personal growth were the means to become satisfied. There were others (*eg* McGregor's

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Theory Y) who argued that effective performance will be found in organisations that motivate people through participative or involving management styles and processes.

These insights led to the observation that there was more to motivation than in Skinner's world. It is not just the extrinsic reward for performing the task that is motivating but the intrinsic task itself can be rewarding. This suggested employees take part actively in decisions based on information that they receive from the work environment, rather than simply responding to economic 'carrots', or, in the view of expectancy theorists, relying on individual needs (as suggested by Maslow). This is also more likely to be true when the individual initiates his/her own behaviour, rather than being dictated to by others (consistent with Theory Y), and where the individual feels competent to perform a task. So external punishment, goal imposition, zero sum competition and such like are said to reduce motivation. Whereas, being able to set one's own goals and receive non-evaluative feedback are likely to increase motivation.

Combining several of these theories, Deci and Ryan set out a self-determination theory that claims that: 'human needs provide the energy for behaviour; people value goals because the goals are expected to provide satisfaction of their needs'.

A final line of criticism of the Skinner approach concerns coercion. It is suggested that people may resent the controlling of their behaviour: not only is self-determination absent, but also expectations of behaviour are externally imposed.

Another line of psychological thinking that is relevant here is that of equity. Equity theorists claim that people seek balance between their inputs and the reward outcomes. In other words, rewards need to match effort. If the reward is too small or unimportant for the effort involved, an individual 'will minimise increasing inputs', and vice versa. These commentators have also asserted that people are uncomfortable about being better rewarded than others. This, however, seems to depend on the social setting. Adams, for example, argued that whether input and reward is in balance is determined on the basis of feelings/perceptions compared with others in relation to social norms. Tyler and Bies came up with related research evidence that suggests that it is procedural justice, the process of how the individual is treated, that is the key element in felt fairness. Distributive justice, the outcome of the reward, is relatively less important.

Summarising this brief review of motivation in the workplace, one can say that staff are more likely to be motivated where:

- work is challenging and satisfying (intrinsic motivation)
- rewards are contingent on the completion of a task (extrinsic motivation)
- the size of the reward, in terms of the relevant social and cultural norms of the organisation, is appropriate to the performance level that justified it
- there is a clear 'line of sight' between action and reward
- employees value the reward on offer
- staff are set clear, specific goals to be achieved over a limited time horizon
- goals are 'challenging yet reachable'
- staff have significant influence over their goal setting
- individuals believe themselves competent to perform their tasks
- staff have sufficient resources to undertake the activity
- employees are allowed to determine for themselves how they meet their objectives
- managers give regular and positive feedback on employee performance, acting as a coach not judge
- employees are involved in the evaluation of their own performance (*nb*: research suggests that employees are tougher markers of themselves than their managers).

It should be emphasised that many of the theories reported above have weak empirical support. Most have been criticised as untheoretical, derived from flawed interpretations of their data or based on evidence from outside the work environment. Moreover, few looked specifically at the role of money as a motivator, seeking out other areas that lead to motivation at work.

The next section looks more closely at the link between money and motivation via pay schemes.

Performance and pay

The ideas on motivation we have reported clearly show up in management thinking on performance-related pay. We have already referred to Scientific Management and the MBO movement. The principles of Human Resource Management also featured the incentivisation of performance as a key feature of the well-run enterprise. Through the 1980s and 1990s there was growing interest in and practice of individual performance-related pay based on the belief that it would lead to both improved productivity and a cultural change in the

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working environment. The next question to ask is whether in reality money seems to motivate employees.

Various researchers (*eg* Wallace and Szilagyi, and Gupta and Shaw) contend that money is indeed a motivator. This is because it can be seen by individuals as a goal in itself, as a means of giving satisfaction, and as a symbol of (internal) recognition or (external) status.

There is a counter view, however, that there is no real research evidence that money does indeed motivate employees. Kahn has argued that extrinsic rewards damage intrinsic job interest. Employees lose focus on the needs of the job in hand and are distracted by the promise of the reward. Performance-related pay has a tendency to produce temporary compliance rather than sustained improvement. It does not change attitudes or behaviour, merely a superficial conformity with what the organisation signals to be important. At worst, a simplistic pay for performance approach is coercive. The risk is that it may also produce the wrong sort of behaviour. For example, as Pfeffer says, individual performance-related pay emphasises individual contribution, whereas the task might require teamwork; it might lead to short-termism when you need a longer-term perspective, or it may encourage conformity when you need challenge.

In truth it is hard to construct the evidence that *proves* that individual performance-related pay works. It is very difficult to identify a causal link between pay and a desired outcome — there are so many intervening variables. The general consensus, however, as expressed for example by Brown and Armstrong, is that such schemes clearly work in some circumstances, but not in others. Results depend on the occupational group and their work setting. You can only really effectively pay performance if you can measure performance, and do it in a consistent manner. As Armstrong pointed out: 'When PRP fails, it is often because the assessment process is flawed.' This fits with Lawler's research in the USA in the 1970s. In a survey of employees he found that objective measures had much more credibility in the eyes of participants than did managerial ratings. Increased transparency of decision making also provided credibility. Of course, objective and verifiable measures are much easier to communicate than the subjective judgements of managers. This understanding gives credence to the commonly held view that a sales force is motivated by the possibility of increased bonuses, whereas this is not true for research scientists. This may be partly due to the different personality traits involved in occupational selection, but it certainly has to do with the contrast in the nature of work satisfaction and the fact that

sales results are unambiguous, whereas research outcomes may be complex.

Reviewing the practice of performance-related pay in the early 1990s, our former colleague Marc Thompson argued that it 'does not serve to motivate (even those with the high performance ratings) and may do more to demotivate employees'. This may relate to an observation by ex Ernst and Young consultant, Barry Leskin, that many PRP schemes are in fact, zero sum games: my gain is your loss. Thompson described how procedural justice was poorly observed in many of the organisations he surveyed. If this is so, then a feeling that rewards have been unfairly distributed will be magnified.

Much of this sort of attack on performance-related pay has been based on evidence from the public sector. Marsden and French, for example, found in a survey of public sector organisations, that only for a minority (between one-tenth and one-third of staff depending on the organisation) had performance-related pay been an incentive to work harder. For the rest, not only had it not motivated, it had damaged relationships between colleagues and hindered teamworking.

Research for the CIPD by David Guest suggests that there is a more complex process at work. The result of his survey suggests that 50 per cent of respondents thought that the possibility of more money would motivate. The other half said it would make no difference to them. Finally, there was a clear, and more or less even, split between those who believed that staff who perform well in their jobs should be better rewarded, and those that disagreed with that proposition. These results bear out our own experience in focus group discussions especially in central government organisations. There tends to be a small minority wholly opposed to a link between performance and pay. A somewhat bigger group is enthusiastic about individual performance-related pay. The large proportion sitting in the middle tend to believe that performance levels do vary within their organisation and that in principle, those who work harder or contribute more ought to be better rewarded. The problem they have is with the skills of managers to exercise their judgement in a fair and consistent manner. They fear favouritism and ignorance.

In a sense for many organisations, particularly private sector companies, it does not matter whether individual performance-related pay motivates. They have seen it as a way of communicating corporate goals and emphasising the importance of delivering results. They regard it as an economic necessity in a world of intense competition and turbulent change. They need the flexibility to adjust pay to suit

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economic circumstances, but also individual situations. Thus performance-related pay has been used implicitly or explicitly to retain key staff. Differential pay increases allow resources to be concentrated on those who it is vital should be retained. Extra remuneration can be used to signal corporate approbation, and to lock these individuals to the organisation with golden handcuffs. Success can also be measured through broader indicators of change in the organisational climate, evidenced by increased employee satisfaction and reduced absence and turnover.

Whilst many organisations (and indeed the government) in the 1980s and 1990s saw individual performance-related pay as a strategic lever to effect cultural change, it seems as if the interest in such schemes is now past its peak. Even then surveys suggest that only 40 per cent to 50 per cent of managers and only between a quarter and one-third of other staff were covered by such systems. The original performance-related pay approaches were not seen to be delivering the right results. There have been problems in objective setting and assessment, especially for jobs whose outcomes are not clear-cut. So what we have seen more recently is the modification of schemes so that they refer to inputs rather than outputs of performance (competence-based pay) or both inputs and outputs (contribution-based pay). Other organisations have focused on variable or team-based pay. Market considerations have also become more prominent, particularly for managerial staff.

These changes (apart from the new market focus) seem to us to be largely a question of relabelling. Organisations are still trying to relate performance to pay, but they have a more sophisticated sense of performance. Many of the problems that seem to have dogged individual performance-related pay may well apply to other schemes. Necessarily, you are emphasising individual contribution over team effort, and this may or may not reflect your work organisation. Whatever the scheme, you still need to find an effective mechanism that links some form of performance assessment with a pay increase. For most organisations this has to be done in a way that motivates the best performers without demotivating the perfectly satisfactory but not exceptional staff. And for the top performers, differential reward is difficult in a low inflationary environment, especially if the organisation is committed to a cost of living floor to their annual pay increases. A lot of effort may go into a system that produces only a small margin between what the best and worst performers receive. And, whatever the system, it needs to meet equal pay requirements.

Implications

So after stating all this difficulty, what can organisations do? Clearly they will want to create the environment where employees are motivated, since this should lead to better performance and outcomes in terms of productivity or quality. Charles Fay of Rutgers University has shown how reward can lift not only employee satisfaction and engagement, but it can lead to business success. To achieve this, organisations need to reflect on the circumstances that will produce motivation, and these are likely to differ by employee group and even by individual. This suggests a segmented approach to reward, different for different groups. This indeed is a feature of the job family approach that is becoming ever more popular. And it suggests that to a degree, reward should be tailor made to fit individual preference — a feature of flexible reward systems.

Pay is likely to be important to attract and, in some cases, retain staff, at least in the private sector. Regarding the link between pay and performance, for some groups, clear and measurable objectives can be set and these can be related to pay. This may incentivise people to work harder or more effectively, but if the incentive is too small (in amount) or too distant (in time) it will only have a limited impact. Even if the conditions of a good incentive are met, you cannot expect people to be sustained by it for long.

There is a greater recognition these days that how the job is done is almost as important as the result. The pensions mis-selling fiasco is just the most obvious example. This argues for a contribution-based approach, where performance is judged on both inputs and outputs. But with respect to the objectives element of the scheme, you would be advised to note the points made at the end of section 1.2. In particular, it is worth reflecting on the fact that there is a strong preference in many companies to cascade objectives down through the organisation. This has the effect of disempowering staff, preventing them from fully participating in objective selection. This is likely to be counter-productive if the aim is to lift levels of engagement.

For other types of staff, the nature of the job content is much more likely to determine the quality of performance. As Herzberg said, 'If you want people motivated to do a good job, give them a good job to do'. For staff in situations such as these, it may be difficult to set clear and measurable targets, and the assessment process may be difficult. So differential rewards are hard to justify. Effort instead should be put into good job design and getting the work environment right. Giving staff recognition for their efforts in other ways than money may be more productive.

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This point may be particularly relevant to the public sector. A recent (2002) Audit Commission survey found that staff joined the public service 'to make a positive difference', to do interesting and rewarding work, and as a vocation. Financial rewards, unsurprisingly, did not feature. Moreover, the Public Services Productivity Review Panel (2002) reported that staff in the public sector rarely mentioned pay as a motivator in their survey. Indeed, they more often stressed that they were not 'in it for the money'. Finally, according to the Audit Commission, pay was amongst a number of factors that affects the decision to leave the public sector, but it is issues concerning the job and the working context that seem to drive resignations. It is the bureaucracy, paperwork and targets, the lack of resources and workloads, a lack of autonomy working on an imposed and irrelevant change agenda, and a feeling of being valued internally and externally, that come before pay in the list of reasons to leave.

But readers from private sector organisations should not dismiss the public sector messages as irrelevant to their own situation. The January special issue of the Harvard Business Review on motivation reveals that , even in the USA, there is disquiet at the way the link between motivation and reward is interpreted in many organisations. Chip Heath at Stanford University, for example, reports that managers are generally poor at judging what motivates people, but they tend to have an 'extrinsic incentive bias'. In other words, they tend to think that people are more motivated by money than they are. Survey evidence in the USA suggests that pay ranks third in importance in the minds of employees, behind factors that relate to job satisfaction. This mirrors a TUC survey in the UK, that also found that money was not the prime issue for people.

In any organisation, pay has to be of a certain level in order to attract and retain staff, however, if intrinsic motivation is what stimulates people, then attention should be focused on how job satisfaction may be encouraged, rather than spending too much time on reward mechanisms that incorporate a strong incentive element.

Positive features in any sound remuneration system will include the fact that it is transparent, and therefore staff can see how it operates. This will put a premium on consistent policy application, that in turn should encourage a sense of felt fairness. Simplicity tends to go with transparency. This helps understanding and allows a 'clear line of sight' between action and reward. Finally, to meet the requirements of equity, the reward should be proportionate to the activity.

Good design, and even more importantly, good implementation, will make the difference between success and

failure. Indeed, the US Consortium for Alternative Reward Strategies concluded from their research that implementation rather than good design was the key to success. In this, communication is critical. Senior management needs to show commitment and staff be allowed to express their views.

So even before implementation, an involving process will tend to gain employee understanding and commitment. This suggests that change in remuneration has to be positioned as something that will produce real, not synthetic, benefits to staff. Fay found this in his research. Process has to fit objectives and objectives have to resonate with the workforce. He also argued that reward approaches needed to align with broader business aims. At the strategic level, as Porter pointed out, if your business objectives are cost containment then the HR systems, including reward should reflect this. If your business imperative is to innovate, your reward approach will be very different. In complex organisations, this reinforces the point that different business units may different remuneration strategies.

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