Paying for Performance
New trends in performance-related pay

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Background

Overview

Performance-related pay (PRP) rewards employees with a financial payment, either consolidated or non-consolidated, following an assessment of their performance and, typically, the achievement of objectives. It was first introduced in the UK on a wide scale in the 1980s and many organisations had high hopes that PRP would bring about cultural change and encourage higher levels of individual and organisational performance (Kessler and Purcell, 1992). PRP now forms a key element of many organisations’ reward strategies – particularly in sectors such as financial services – but is increasingly more likely to be applied as part of a broader approach that does not rely on performance pay alone to encourage higher levels of motivation and commitment.

Since its early introduction on the UK reward scene, reward specialists, organisational psychologists and academics have disputed whether or not PRP is an effective motivational tool. Some of the potential advantages of PRP are that it can provide a direct incentive, is a tangible means of recognising individuals’ achievements, and provides the flexibility to retain key staff. On the downside, critics of paying for performance in this way say that it can be discriminatory, demotivate the majority of employees at the expense of a few high performers, and undermine ‘felt fair’ perceptions of equity.

PRP is built on the premise that reward can foster the right behaviour and money is a potentially powerful incentive to influence the amount of effort that employees will exert on behalf of the organisation. Some theorists believe that money can act as a goal in itself and can be valued by employees as a symbol of external status and internal recognition. But others contend that early proponents of PRP failed to appreciate the complexity of the wider employment relationship and the extent to which financial reward can act as a long-term satisfier. ‘Needs’ theories such as those developed by Maslow and Herzberg place a great deal of emphasis on the intrinsic aspects of the job, and argue that people can gain the greatest satisfaction from work factors such as responsibility, achievement and recognition. Other critics of PRP caution that such pay schemes are coercive and can encourage the wrong type of behaviour, for example, by focusing on individual effort at the expense of teamworking.
The theoretical arguments relating to PRP are not adequately supported by empirical evidence, while the practical research studies that have been undertaken are also contradictory and their conclusions often depend on the choice of the particular sample group, be it managers, employees or HR practitioners. For example, surveys of management typically find that most managers are in favour of rewarding high performers and feel that Individual performance-related pay (IPRP) does contribute to organisational effectiveness – perhaps because this fits with their own values and successful experience of PRP. Even where practical research has identified benefits, it is clear that no type of performance-related pay scheme is universally suitable for every type of organisation and PRP will not, on its own, bring about organisational change.

Is PRP alive and well?

Mark Twain’s famous statement that ‘reports of my death are greatly exaggerated’ – issued after his obituary had been mistakenly published in the US – could be applied to performance-related pay. Initially hailed as the solution to motivating staff and encouraging higher levels of productivity, PRP subsequently suffered a reaction a decade later when it became apparent that it may not live up to expectations. As Armstrong (1999) notes: ‘In the post-entrepreneurial 1990s there has been a backlash against performance-related pay. First-generation schemes introduced in the 1980s were not delivering the expected results. A number of research studies failed to demonstrate any causal link between merit pay and performance and productivity.’ But, say Brown and Armstrong (1999), performance-related pay is neither dead nor dying; the spread in incidence has undoubtedly slowed, but it is continuing to be applied and grow. Furthermore, the practical problems in implementation and operation are increasingly well recognised and documented.

IPRP is defined as a pay progression system where individuals receive a financial reward based on their performance. Lawson (2000) defines the diversity of schemes that might be called performance-related as follows:

- where individual performance criteria are established so that actual individual performance can be judged or assessed against the performance criteria established

- where links are established between the level of individual performance as assessed and the level of reward received by the individual

- where the actual relationship between pay and performance is established by a managerial assessment of performance which may be based on either objective or subjective criteria

- where it is assumed that these links will lead to increased organisational performance through improved individual performance which arises from higher rewards for improved performance

- where a formal performance management system is used to establish the linkage between the performance of the individual and the performance of the organisation.
The delivery of the performance award may either be through base pay (sometimes called merit pay) or through a (usually non-consolidated) bonus.

Since its introduction in this country over two decades ago, there has been an increasingly polarised debate about the efficacy of performance-related pay. In the early days IPRP was indeed regarded by its advocates as the panacea that would encourage greater levels of employee motivation and commitment and foster high performance work cultures. It has been suggested that it is the naivety of these initial expectations, and a lack of sophistication in how IPRP schemes were implemented, that explain the subsequent revolt against performance-related pay.

When it was first introduced to the remuneration scene in the late-1980s, IPRP quickly became the pay progression system of choice for many sections of white-collar workers, typically replacing traditional, across-the-board rises. Its first foothold was in the private sector – for example, financial services – but it was not long before IPRP was rolled out across significant sections of the public sector, including the civil service during the 1990s. The only section of the economy where IPRP has not become commonplace (for at least some groups of employees) is the shopfloor, mainly because significant sections of manufacturing are covered by collective bargaining for pay setting and because of the proliferation and persistence of other performance-type schemes like productivity bonuses.

Contrary to assertions from those who opposed to IPRP in the 1990s, that performance-related pay had had its heyday and was now on the way out, a large-scale survey by the then Institute of Personnel and Development in 1998 found that IPRP was here to stay (IPD 1998). ‘Contrary to the popular belief that organisations are becoming disillusioned with IPRP schemes in particular, the results strongly suggest that the use of all forms of performance pay is growing.’ The survey, of 1,158 organisations, covering 1.5 million workers, found that 40% of respondent organisations operated merit pay systems and over half of private sector companies did so. Nearly six in ten of these schemes had been introduced in the previous five years.

More up-to-date survey evidence shows that the premise on which IPRP is based – that is, rewarding people according to their level of performance – remains a fundamental principle of many organisations’ reward strategies. For example, the annual reward management study by the Chartered Institute of Personnel and Development (CIPD) (2007) identifies rewarding high performers as the second most important reward strategy goal (after supporting business aims). Where organisations operate a cash bonus scheme or incentive plan, there is a firm indication that employers are increasingly individualising these non-consolidated payments, with 64% of organisations using individual performance as a factor on which to base awards, up from 56% a year earlier. A survey of 431 organisations by the IRS (2006a), meanwhile, found that ensuring the company’s reward offering pays for performance was the most common reason cited for operating a reward strategy, mentioned by 29% of those organisations with a strategy. Another annual survey by IRS (2006b) records performance-related pay as the most commonly used reward strategy, with 55% of respondents saying that they had used it
for at least some employees. But this survey also marks the second consecutive year that IRS has recorded a fall in the use of merit pay. The most recent largest survey of British workplaces, the 2004 Workplace Employment Relations Survey (WERS), meanwhile, finds that merit pay alone was used in just 9% of workplaces. These differences in results can be explained by differences in the samples used and the questions asked.

Brown and Armstrong (1999) asserted that ‘performance-related pay is not dying, but it is changing’, and this prediction is borne out by the findings of more current reward studies. The CIPD (2007) annual reward survey indicates that, when it comes to pay progression, the majority of employers (79%) take into account a number of factors – what it terms the ‘combination’ or ‘hybrid’ approach, with senior managers and above more likely to be assessed solely on their performance than other employee types. Of those employers that use a combination approach, the most common progression criteria is individual performance (80%), followed by market rates (65%) and individual competence (47%).

IPRP has always dominated the reward scene in some sectors more than others, and this trend continues. For example, a survey of finance sector pay by IRS (2006c) found that ‘performance-related pay is still the key reward tool’, with four-fifths (79%) of pay awards containing a merit-based element and 72% of awards based solely on performance. In the public sector, where IPRP enjoyed a somewhat later debut, according to IRS (2006d) only 16% of pay settlements included an element of performance-based pay, compared with 29% a year earlier.

**Motivation and reward**

The underlying rationale for performance-related pay is based on theories of motivation and the degree to which financial reward can influence an individual’s performance. The view that the right behaviour can be encouraged through reward and discouraged through punishments derives from many years of psychological thinking. For behaviourists like Skinner (1974), learning only takes place through external positive and negative reinforcement – the ‘carrot or stick’ approach to reward. Taylorism applied this thinking to financial rewards, contending that money was the sole motivator for workers to perform. This is an essentially employer-centric view of reward, based on the premise that behaviour can be controlled and moulded to suit employer needs. It is a view that takes no account of employee reward preferences.

This perspective has been hotly contested by other motivational theorists. For example, expectancy and goal theorists put the emphasis on cognition thought processes – that is, the decisions people make about how far to participate and perform in the workplace. For goal theorists, future goals or anticipated outcomes can be used to influence behaviour and motivation, and the mere existence of goals can lead people to behave in ways that mean they will attain their goals. This does not even necessarily imply that financial reward is needed; rather, there is a strong indication in goal theory that objective setting is a powerful motivational tool in its own right.
Expectancy theory and pay satisfaction

Source: Ducharme, Singh and Podolsky, York University, CBR, 2005

Goal theory was refined in a number of ways through expectancy theory. Porter and Lawler (1968), building on earlier work by Vroom, developed the central hypothesis that motivation is dependent on whether the outcomes hold psychological value or ‘valence’ for the individual. Effort would be made where people expect to be rewarded for it, but there needs to be a clear line of sight between the effort and expected reward. The reward needs to match the effort expended – if the reward is too small or unimportant for the effort involved, an individual will not try that hard, so ‘valence’ has both quantitative and qualitative dimensions – whether the reward is of the right kind and whether there is enough of it. This theory has implications for the level of awards that are paid under PRP schemes. There is also the contention made by Adams (1965) that people are uncomfortable about being better rewarded than others, although this seems to depend on the social setting.

‘Needs’ theories, such as those put forward by Maslow and Herzberg also challenge the more mechanical motivational theories of Skinner and Taylor. Herzberg (1958), for example, identified pay as a ‘hygiene’ or ‘dissatisfaction avoidance’ factor – meaning that money cannot create satisfaction but can cause dissatisfaction. In contrast ‘satisfiers’ or ‘motivators’, such as achievement, responsibility and recognition, are intrinsic to the job and can bring much longer-term satisfaction. In short, pay is but a short-term motivator and the greatest satisfaction, and therefore potentially motivation, can be derived from the intrinsic task itself. This is also more likely to be true when the individual initiates his or her behaviour and feels competent to perform the task – consistent with McGregor’s ‘Theory Y’.

PRP and fairness

Tyler and Bies (1990) suggest that it is procedural justice – the process of how someone is treated – that is the key element in ‘felt fairness’. Distributive justice, or the outcome of the rewards, is less important. This is borne out by research done by Folger and Konovsky (1989) and McFarlin and Sweeney (1992). Both studies showed that reward system process was more important than reward system content. Perceptions of
distributive justice only predict immediate satisfaction with reward outcomes, whereas perceptions of procedural justice are associated with a broader range of attitudes, like organisational commitment and the quality of employee relationships with bosses. This holds true regardless of whether or not reward decisions are favourable to employees. Procedural justice, that is, the fairness of the reward allocation process was found to be more important. Indeed, where procedural justice is rated as high, there is evidence to suggest that distributive justice has less impact on employees (McFarlin and Sweeney, 1992). This has important implications for employers, who might do well to focus their investment in time spent getting reward processes right rather than on the size of reward at stake.

However, further research has emphasised that fair procedures alone are not enough. It points to the importance of interactional or interpersonal justice. Bies and Moag (1986) emphasise that procedures cannot exist without being enacted and that people may regard the way in which procedures are followed as equally, or indeed, more important than the existence of the procedures themselves. Firstly, there is the sincerity with which procedures are followed, for example, the degree to which managers truly consider employees’ views on pay when consulting them. Secondly, interpersonal sensitivity comprises the politeness and courtesy with which an individual is treated when a decision is being made or implemented, which affects the maintenance of their sense of dignity and self-worth, often referred to now as ‘interpersonal justice’. This may include subtle and intangible aspects of communication such as tone of voice and body language in face-to-face interaction.

**Does PRP work?**

There is much debate on the question of whether or not money can act as an effective motivator. Some researchers (eg Wallace and Szilagyi, and Shaw et al) 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. By contrast, Kohn (1993) is a firm opponent, arguing that incentives succeed at securing one thing only – temporary compliance. According to him, there is no firm basis for the assumption that paying people more will encourage them to carry out better or more work. At worst, a simplistic pay for performance approach is coercive and could encourage the wrong type of behaviour. For example, says Pfeffer (1998), IPRP focuses on individual contribution whereas the task may require teamwork; it may lead to short-termism where a longer-term view is needed, or it may encourage conformity when you need challenge. McHenry, similarly, argues that softer management approaches have a greater effect on effort than carrot and stick techniques like PRP. This may be because controlling behaviour is not easy (‘an organisation should not expect its employees to appreciate having their behaviour “motivated” with a reward programme’ to quote Hansen, Smith and Hansen) and that trying to do is, according to Professor John Hunt, ‘based on a false assumption: that organisations can be administered scientifically, that emotions and inequities can be squeezed out by applying a common, objective
system’ (quoted in Brown and Armstrong, 1999). Moreover, as Barry Leskins has suggested PRP is usually ‘a zero sum game’ – for those that benefit others lose out.

The debate on motivation and pay has its limitations as the majority of psychological theories lack any firm empirical support based on organisational findings and many of the arguments and counter arguments are more matters of assertion than fact. Indeed, the relationship between motivational factors and other variables in the workplace mean that it is not easy to conduct practical research on the effectiveness of IPRP – it is difficult to isolate the impact of that element of the pay scheme and therefore establish a causal link. As a Management Today article put it: ‘No-one can prove that performance related pay improves performance, but no-one can prove it doesn’t either’ (Oliver, 1996).

The results of studies examining PRP are also typically influenced by the nature and attitudes of the respondent group, for example, whether it is HR professionals, managers or employees who are giving their opinions. For instance, for many senior managers, PRP fits with their idea of an individual and flexible culture that recognises and rewards achievement. They find the suggestion that pay does not motivate counter intuitive, partly because they themselves could be motivated in this way and, by definition, if these managers have progressed in their careers to reach management, they may not have experienced the more negative connotations of IPRP. Chip Health at Stanford University (quoted in Morse, 2003), for example, finds that managers are generally poor at judging what motivates people and they tend to have an ‘extrinsic incentive bias’. This point has been put more graphically by an American commentator (Andrew Lebby): ‘just as it is easier for some parents to show love with gifts rather than hugs, it is often easier for organisations and managers to show gratitude with money than with words’ (1993).

Where research has been carried out in a work setting, the evidence is as contradictory as the theoretical arguments for and against PRP. On the more positive end of the research spectrum, the 1998 IPD study found that three-quarters (74%) of respondents believed that PRP improves individual and organisational performance. However, less than a third of these managers had conducted a formal evaluation to assess the effectiveness of their merit pay schemes. Whether their successors had carried out such an evaluation is open to doubt. The risk here is that managerial perceptions of motivation may turn out to be inaccurate: to quote Graham White, HR director at Surrey County Council, ‘the cat bringing you a dead rat as a reward shows that the cat knows nothing of what interests you.’

In the US, Huselid (1995) found a correlation between high performance work practices (including close links between appraisal and pay) and organisational performance. A smaller scale study by Thompson (1998) of 400 companies in the aerospace sector, based on a more sophisticated measurement approach of added value per employee, also identified a positive link between IPRP pay schemes and this measure.

There are also a number of studies that looked at the relationship between people management practices (including reward) and organisational performance. There is
evidence to support the contention that reward affects performance. For example, financial incentives had the greatest effect across a wide range of motivational levers – training, work design, etc. – according to research done by Guzzo et al. Several papers were also able to point to a positive link between reward and performance, but the type of reward involved varied. So, for example, Kruse (1993)\(^1\) identified an increase in productivity linked to profit sharing; whereas Kaufman (1992)\(^2\) saw the same effect via ‘gainsharing’; Ichniowski et al. (1994)\(^3\) focused on team awards; and incentive pay benefited profitability in a study undertaken by Banker et al. (1996). A meta-analysis by Kling\(^4\) on US studies confirmed this general point by finding that compensation linked to either worker or firm performance lifted labour productivity. David Guest also found that IPRP is associated with high performance or high commitment HRM and The Work Foundation reported that the higher the proportion of staff in receipt of PRP, the higher the organisational added value.

However, other research often contradicts the results and points to the opposite conclusion. Thus in contrast to Guest and The Work Foundation, Fernie and Metcalf reported that IPRP and merit pay were insignificantly correlated with firm performance. In a more specific example, Marsden and Richardson (1994) looked at merit pay in the Inland Revenue and found that it had only a slight motivational impact on staff, largely because people perceived the system as unfair, with ratings not necessarily reflecting the level of performance due to the quota system and favouritism. A study by Thompson (1992) indicated that his initial findings failed ‘to provide convincing evidence of a link between IPRP schemes and improvements in productivity.’ Brown et al, comparing WERS data from 2004 and 1998, found no association between PRP and job satisfaction, rather perceptions of job security and employee relations climate had more of an effect. Having said that, bundles of HR practices, including PRP, did affect satisfaction (2006). McCausland et al (2006) used British Household Panel Survey (BHPS) data to examine the relationship between receiving PRP and job satisfaction. They found a positive impact of receiving PRP occurred only for more highly educated workers, while controlling for the possibility that workers will self-select themselves into jobs and organisations which have their preferred pay system. This shows the differential effects of PRP and points to a potential need to choose carefully between reward systems that may be more or less appropriate for different groups of workers.


An analysis of the available empirical evidence led Brown and Armstrong (1999) to two important conclusions:

- PRP cannot be endorsed or rejected universally, out-of-hand, as a principle. There are ‘situational variables’ that indicate PRP schemes are found to work in some settings, and for some employee groups, and not in others.

- No type of performance-pay scheme is universally successful or unsuccessful. The key issue for managers is not only to pick the appropriate pay scheme for their own situation, but also to work to maximise the potential advantages and minimise the potential disadvantages.

Brown and Armstrong (1999) quote Bowey’s research indicating that the performance pay scheme design bore no correlation with successful outcomes – rather, success was far more dependent on the scheme’s support and communications systems.

The unrealistic expectation that PRP could act as a major lever for organisational change was based, according to Armstrong (1999), on overly simplistic assumptions about the instrumental value of money as a motivator without taking account of the lessons from expectancy theory, the problems with administering PRP fairly, and the fact that it may work better in some organisations than others. According to Armstrong, ‘when PRP fails, it is often because the assessment process is flawed’. In other words, a PRP scheme is only as effective as the performance management system on which it rests. It was this growing understanding of the practical application of PRP that has led to a more sophisticated approach to its use in many organisations today. It also explains why, for many employers, PRP forms just one part of the reward strategy. For example, the concept of ‘total reward’, where merit pay or incentive bonuses are viewed as just one element affecting an individual’s employment experience, is having more resonance with employers who are attempting to meet employees’ rising and diverse expectations of what they want from work.

<table>
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<tr>
<th>Table 1: The pros and cons of individual performance-related pay</th>
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<td><strong>Advantages</strong></td>
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<td>Provides a direct incentive</td>
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<td>Tangible means of recognising achievement</td>
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<td>Generates a ‘performance’ culture</td>
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<td>Improves goal setting</td>
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<tr>
<td>Improves individual performance, productivity, quality of work etc</td>
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<tr>
<td>Focuses employees on improvement</td>
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<td>Rewards best performers</td>
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<td>Can support organisational change</td>
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<td>Identifies poor performance</td>
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<td>Flexibility may help retain valued staff</td>
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*Source: Suff P (2001a), The new reward agenda, Industrial Relations Services*
Implementing PRP

Overview

The failure of some of the early, unsuccessful PRP schemes in the 1980s has been partly attributed to the mechanistic way in which they were implemented. Insufficient account was taken of the organisation’s unique characteristics, its culture and the reward scheme’s relationship with the business strategy and HR practices. The research carried out on some of the first-generation PRP schemes revealed a range of organisational factors that are either favourable or unfavourable to the introduction of PRP. For example, PRP is more likely to be successful and fit with the organisation if there is an entrepreneurial culture with an emphasis on growth and the achievement of financial objectives, if top management is convinced of the reward scheme’s effectiveness, and if the organisation can fund performance increases that are significant enough to motivate people.

More recent research evidence points to the evolving nature of PRP over the years, with many organisations now having a more sophisticated understanding of performance and using a variety of different approaches to motivate and reward staff. For instance, some employers have fine-tuned their performance appraisal systems to ensure that staff are not measured on hard objectives alone, but are assessed on their competence, skills and behaviour – ‘contribution-related pay’. Other organisations have moved to a ‘total reward’ approach, whereby many different elements of the employment experience combine to encourage greater levels of commitment, and PRP, while still important, forms just one element of the reward package. Other changes to PRP include the move, particularly in sectors such as financial services, to paying performance-related increases as bonuses or ‘variable pay’ to prevent a reward of one year’s good performance being consolidated.

The fact that PRP is, by its very nature, more suitable for some organisations and employee groups than others, has become evident in recent years. It is for this reason that PRP is not widespread in the public sector, for example, despite strong government endorsement of it across the sector. It is also from the public sector that much of the research evidence against PRP emanates – one survey of civil service PRP schemes found...
that the low level of award failed to motivate and PRP was discriminatory. Other studies have reinforced the view that public sector workers may not be best motivated by financial reward and highlighted the importance of more intrinsic motivators such as quality relationships, good communication and delegation of responsibility. PRP can also be problematic for knowledge workers: it is often difficult to measure their outputs and, again, many knowledge workers tend to be motivated by practices such as professional development and achievement in their role.

Clearly, PRP is better suited to other employee groups, such as sales staff and customer service operators, as it is more straightforward to devise clear and measurable objectives against which to assess their performance. But even for these groups of staff, it is necessary to incorporate measures that take into account the quality of the customer service provided and employees’ relationships with clients.

It is widely acknowledged that, where PRP does fail, it is more likely to be because of ineffective implementation and management of the scheme as opposed to poor design. For example, the US Consortium for Alternative Reward Strategies (CARS) concluded from their research, implementation rather than good design was the key to success (reported in Thompson and Milsome, 2001), but McAdams (the Director of CARS) also concluded that ‘the bottom line is simple: reward plans work when properly designed and supported’ (1993).

There are a number of necessary steps to an effective planning and implementation process, such as clearly defining and jointly agreeing the scheme’s objectives, developing a robust performance management system, providing training, and communicating with the whole workforce on the scheme’s operation. Transparency and good communications should characterise any reward scheme, but are even more crucial in PRP schemes where some employees receive higher awards than others. The confidence and competence of line managers to manage PRP and its supporting performance management system on a day-to-day basis is a key determinant of the scheme’s success. Line managers need to provide honest and ongoing feedback on performance, have the ability to differentiate between varying levels of performance, and feel that they ‘own’ the PRP system if it is to be successful.

**Reward alignment**

According to Brown (2001), even the question ‘Does PRP work?’ is the wrong starting point and reflects the overly simplistic approach, and subsequent failure, of many early schemes. Organisations imported schemes from elsewhere with little thought given to supporting processes, such as objective- and target-setting. The best practice approach risks organisations applying ‘universal’ solutions that are ill suited to their circumstances. In order for any PRP scheme to be successful, organisations need to follow a ‘reward strategy pathway’. This involves taking into account the organisation’s overall performance goals and how to reflect them in the pay system. Other questions that need asking include: How do staff contribute to these goals? What is the organisation’s culture through which employee attitudes and behaviours are mediated?
How can HR policies further their achievement? It is only by answering these and a number of other questions about the organisation’s business and performance models that an organisation can begin to consider the detail of a PRP scheme, the levels at which they should operate, appropriate measures and operating arrangements.

In short, what organisations should be ensuring is that there is a process of vertical integration (aligning reward strategy with business strategy priorities), together with horizontal integration (ensuring that PRP is supported by the organisation’s other people management policies and practices — reward, resourcing, employee relations, etc). In particular, there must be congruence between the aims of reward and performance management. You would not want, for example, the performance appraisal system to be emphasising development when the reward system is performance determined.

Unless the aim is to challenge the prevailing culture (and many PRP schemes do indeed have that intention), there should be an attempt to align reward with organisational culture. Performance pay works best when there is a close congruence between organisational and employee interests. This can be seen in high trust environments where employees respect the competence and integrity of their managers in making performance judgements. For its part, where reward reflects degree of acceptable difference in social distance, between the best and least well rewarded under PRP, then the scheme is likely to be accepted. Thus a sales team may tolerate wider differentials than a administrative/clerical unit. This relates to another point: it is justifiable to have larger incentives for those jobs where there is the capacity for greater variations in performance. A clerical officer does not have the same freedom to shape his/her job and lift performance, as someone with greater job autonomy and the capacity to impact on performance.

Organisations should also take account of the external and corporate contexts within which a reward strategy and policy needs to operate. The 2004 WERS found that the degree of product market competition faced by companies was a factor influencing the existence of incentive pay schemes, such as IPRP. Half of those organisations that assessed the degree of competition in their market as ‘very high’ had in place PRP schemes, such as merit pay. Thus, the external environment and competitive element of an organisation’s operations – for example, its need to ensure sales or growth targets are met, or deliveries made on time – should influence its decision to adopt IPRP.

The favoured approach, therefore, is to follow best fit rather than best practice. Contingency theory (as it is also called) means that, to be effective, PRP should be appropriate to the organisation’s unique characteristics and needs.
Suitable conditions for PRP

Nonetheless, some authors would suggest that there are particular conditions favourable to PRP, or unfavourable to it. According to Armstrong (1999), PRP and success in introducing and operating PRP is most likely if:

- the culture is entrepreneurial with an emphasis on growth, competitiveness and the achievement of financial objectives
- top management is convinced that PRP can bring about cultural changes leading to significant performance improvements
- performance management processes are in place that include the agreement of objectives integrated with the overall objectives of the organisation, that involve feedback and review, and that provide a sound basis for making fair and consistent pay decisions
- line managers ‘own’ the scheme and believe that it will help them to achieve their objectives
- line managers are skilled in the process of objective-setting and giving feedback on assessing performance
- the expectation of what employees need to do to achieve a reward are clarified
- the scheme is transparent so that everyone knows how to it works – as Lawler (1998) says: ‘If you are doing something good, flaunt it! If you feel you have to hide it, you shouldn’t be doing it’
- there is a tradition of involving employees in decisions on matters that affect them
- the organisation can afford to award worthwhile PRP increases
- PRP processes are integrated with other personnel and development practices.

Some of these conditions relate to the business strategy, its interaction with the external environment, and whether PRP would support the organisation’s corporate goals. Others relate to the dominant working culture and whether there is a tradition of employee involvement, while others still require that supporting mechanisms be established alongside the scheme’s implementation. The last condition refers to horizontal integration point made earlier.

Crucially, PRP must be built on an effective performance management system, with clear objectives that support business goals, and line managers that are confident and competent in assessing performance against individual objectives.
Moving PRP on

Because the PRP original schemes were not seen to be delivering the right results – for example, there have been problems in objective-setting and assessment, particularly for jobs whose outcomes are not clear-cut – schemes have been modified. IRS (1998) reports an array of changes to enhance their effectiveness, including:

- improved performance management techniques
- moves to ‘multi-rater’ or 360-degree appraisal
- the use of a wider range of performance criteria, with different aspects of performance linked to different pay mechanisms
- the incorporation of competencies
- the blending of team and individual measures of performance
- higher levels of employee communication and involvement.

In response to concerns over the crude or formulaic application of PRP, many employers have developed a more sophisticated understanding of performance. One prominent development is the broadening out of performance to include both inputs and outputs – ‘contribution-based pay’ (Brown and Armstrong, 1999). Rewarding the whole of an individual’s contribution reflects a more holistic approach to pay progression, where success in achieving predetermined objectives is complemented by an assessment of how the individual has worked towards these objectives, usually based on the competencies they have demonstrated in doing so. This approach can help to overcome some of the main criticisms of PRP schemes: for example, that they encourage short-term compliance, that they inhibit teamwork, and that they demand a blinkered focus on quantifiable outcomes to the exclusion of quality. This is increasingly important given the realisation that customer service can be the differentiating factor in business success or failure.

Table 2 summarises the main differences between IPRP and contribution-related pay.
Table 2: A comparison of PRP and contribution-related pay

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<th>Pay for performance</th>
<th>Pay for contribution</th>
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Source: Armstrong M (1999), Employee reward, Institute of Personnel and Development

According to Brown and Armstrong (1999), paying for contribution represented the missing dimension in reward. They describe contribution-related pay as a mixed model: it attempts to overcome some of the problems associated with IPRP and take it to a new level. Contribution-related pay encapsulates a much more in-depth view of performance; in this approach inputs, such as competence, skills knowledge, experience, behaviours, and commitment to the organisation’s values all come into play. For example, because of this focus on inputs as well as outputs, there may be greater scope to allocate higher rewards to those individuals developing their level of competencies and skills, enabling rewards to reflect overall contribution better. It also means that behaviour necessary in today’s workplaces – for example around important areas such as innovation and creativity – can be encouraged and rewarded (Suff, 2001a).
Case study
Cisco Systems

A strong performance management system underpins all decisions concerning the financial reward Cisco employees potentially receive. Individual appraisals are based on an assessment of the person’s overall performance in their role as well as measurement against competencies such as leadership. When making a judgment on the level of increase, the individual will be assessed from the perspective of current performance and market position. In this way, the appraisal process is both retrospective and aims to develop the person’s future contribution to the company (Suff 2001a).

Case study
Canon (UK)

Canon UK’s performance management process uses competencies that are linked to pay and reward. Employees receive an overall rating for the achievement of objectives and competencies. Following this, line managers make a judgement based on the ratings as to where employees lie on a one-to-five scale. In turn, this scale corresponds to Canon UK’s pay scales and enables an employee to have both an annual market-based pay review (determined by job families and equivalent external job markets) and a PRP review. According to the HR manager, the competencies help people to understand their role by ensuring that the company measures not just what people do but how they do it. By having both dimensions, the company is able to really differentiate between a competent and high performer (Competency and Emotional Intelligence, 2006).

The development of IPRP is confirmed by Incomes Data Services (IDS 2004). It finds that the character of many organisations’ approach to PRP has changed, with a mixture of performance and market-related systems. For example, in the finance sector the performance element of pay reviews has shifted from basic salary increases to annual bonuses.

IDS also reports that in financial services, where there is increasing reliance on market rates and benchmarking, individual performance has sometimes been squeezed out of annual pay reviews. One result has been that many of the highest performers on salaries well above the market rate are receiving very small or even no rises in consolidated pay. Because staff have been used to receiving higher performance awards, companies are experiencing difficulties in meeting employees’ expectations. Some companies, such as Nationwide (see case study below) have decided to separate performance and progression arrangements in order to ease the difficulties with tying pay to market rates. This does not mean that progression is no longer related to performance but staff can differentiate clearly between awards that are progression-based and those that are performance-based.
In previous years, PRP increases had been applied to the target or market rate rather than to actual salaries. This meant that all staff with the same performance rating received the same increase, in effect slowing progression for staff above the market rate. Following feedback from staff the company decided to apply the performance-related increases to actual salaries - with more than 50% of staff above the target this was a big issue for staff. The increases for these staff were split into consolidated and non-consolidated increases, with the increase derived from the target rate consolidated into base pay and the remainder non-consolidated (IDS 2004).

Consolidated payments versus bonuses

PRP increases may be added cumulatively to basic pay – that is, consolidated – until either the maximum rate for the grade or a limit within the grade, defined in terms of a level of performance, is reached. Alternatively, increases may be paid as a cash bonus, known as ‘variable pay’, and not consolidated within an individual’s salary. In some organisations individuals are only eligible for such bonuses when they reach the top of their pay bracket, or there may be in-range bonuses on offer either instead of, or in addition to, performance-based base pay progression.

In an environment of tight budget controls, variable pay enables the organisation to avoid the continuing, fixed labour costs of consolidated performance increases. There is also the view that a larger one-off payment can represent a more motivating reward than the same amount of money paid incrementally. Awarding people immediately after the achievement also provides a clear link between the award and performance. Non-consolidation is especially important in a low inflation climate, because fairly large rises in total pay can be awarded to high performers to compensate for relatively low increases in salaries without incurring substantial additional fixed costs (Suff, 2001a).

Case study

Department of Trade and Industry (DTI)

At the DTI the 2006 pay award consisted of two elements:

**Progression** - progression awards provide, for example, an increase of two steps on the pay range for specific groups of employees who received an overall performance assessment of ‘successful’ or ‘highly successful’. For staff at or above the 2005 target rate, consolidation of the progression award depends on performance: those with an overall assessment in 2005/06 of ‘improvement needed’ received their one-step increase on a non-consolidated basis; those with an overall assessment of ‘successful’ received their two-step increase on a non-consolidated basis; and those with an overall assessment of ‘highly successful’ received one step of their increase consolidated and one step non-consolidated.

**Performance** - in addition, ‘highly successful’ performers received an additional, non-consolidated performance award equivalent in value to 2.6 steps based on the 2005 rate (IRS 2007).
While bonus schemes can focus on a measure of performance at just the individual level, many employers operate multi-level or multi-factor schemes that enable them to also link the reward at a team, department or company-wide level. This approach enables the organisation to link the achievement of an individual’s personal objectives to its wider strategic and operational goals. An employee’s own performance can be included as a factor with the measure generally derived from individual appraisals. This is the case in Yorkshire Building Society’s Accord Bonus Scheme, where, at the end of 2007, ratings will be made against behavioural competencies and annual performance goals for every role. Similarly, at United Utilities North West, employees typically have five to eight individual performance objectives against which they are assessed for part of their bonus (IDS 2007).

**Case study**

**Yorkshire Building Society**

The Accord bonus scheme at Yorkshire Building Society is a multi-factor scheme and was updated in 2007 to place greater emphasis on individual contribution. All staff working for the Accord Mortgage subsidiary except senior management and the intermediary sales team are covered by the bonus. The scheme is designed to:

- motivate people to achieve Accord’s 2007 growth objectives
- enhance the relationship of the business with its customers and provide an improved basis for long-term growth
- be based on factors that people can influence positively
- be easy to understand.

There are three key factors:

1. mortgage asset growth
2. broker surveys
3. individual performance – at the end of the year, ratings are made against both behavioural competencies and annual performance goals for every role (IDS 2007).

**Different groups require different treatment**

If the practical research and ongoing debate about the effectiveness of PRP has taught pay specialists and HR practitioners anything, it is that PRP can work, in certain circumstances and if it is managed properly – but it is not suitable for every organisation or, indeed, every employee group. It is this proven principle that partly explains the variation in its incidence between sectors and occupational groups.
Public sector

Although parts of the public sector do operate merit pay schemes, this form of reward is far less common than in the private sector, despite successive governments having promoted IPRP across the sector. WERS (2004) found that PRP systems (that include both merit pay and payment by results) were present in 44% of private sector workplaces compared to 19% of public sector workplaces. In the NHS, PRP has largely been restricted to the executive level. In local government, a PRP scheme for teachers was piloted but was quickly abandoned (Reilly, 2003b).

Much of the evidence against PRP emanates from the public sector – perhaps because sections of the people who work in this sector may not be the most open to the ethos of PRP, placing more emphasis on other motivators. For example, the Public Services Productivity Panel (2002) reported that employees ‘were not in it for the money’, instead emphasising the importance of more intrinsic factors, such as quality relationships, delegation of responsibilities, good communication, and participation in work decisions. Marsden and French (1998) looked at IPRP in the public sector and found that only for a minority (between a tenth and a third of staff depending on the organisation), had PRP served as an incentive to work harder; for the remainder, it had damaged working relationships and hindered teamwork. Makinson (2000) studied performance pay in the civil service and concluded that such pay systems could be discriminatory, that the low level of awards failed to be motivational – partly because the differentials in performance pay were so narrow. He also argued that IPRP made little sense where individuals all worked to common goals. He proposed team-based pay for these groups. Makinson’s critique had some initial impact on the pay reform process in the civil service. Team-based pay was trialled in a number of departments, but at a very aggregate level and, as a consequence, was found wanting. The use of non-consolidated bonuses to reward individual performance has, however, become a feature of many departments’ pay arrangements (IDS 2004).

As David Marsden says, public sector staff do not always have the same clear goals as those in the private sector, with too many conflicting priorities through trying to serve too many masters. As Reilly (2003b) says, it is not easy incentivise the police to catch more criminals, Customs and Excise officers to increase their detection rate or ambulances to get to accidents more quickly. A target can be set, but care needs to be taken over the process of reaching the goal: the public might complain about over-enthusiastic police, customs or other public servants.

Although there is evidence that at least some professional groups choose to work in the public sector because it is a vocation, this does not mean that public sector workers are uninterested in the link between performance and reward. Research for the CIPD by Guest (1999) suggests there is a complex process at work. His study found that 40% of respondents did not believe that they were fairly rewarded for the effort they put into their work, while half thought that the possibility of more money would motivate. The other half said it would make no difference to them. These results bear out in IES focus group discussions: there seems to be a small minority opposed to a link between pay and
performance but a large proportion sitting in the middle think that, as a principle, those who work harder or contribute more should 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.

Private sector

From a certain perspective, whether or not IPRP motivates is not necessarily the key question for many private sector employers. IPRP is viewed as an important vehicle for communicating corporate goals and delivering results. Furthermore, in times of rapid economic change and increased budgetary restraints, they need the flexibility afforded by IPRP and the ability to tailor differential pay increases to retain key staff – the ‘golden handcuff’.

But this is a generalisation, and an assessment of whether or not IPRP is suitable must take account of a range of organisational factors, including the type of work being done. For example, Deathridge (2002) says that call centres are ideally suited to PRP schemes, largely because the industry relies on almost continuous assessment of ‘hard data’, such as abandoned calls, speed of answer, talk time and total wrap time, which provide a regular and objective measure of individual and team performance. However, the introduction of PRP is not as common as one would suppose. Noetica’s 2002 survey found that only 11% of managers used performance related pay as a motivational tool. IRS (2006e) found, in its annual survey of the sector, that the use of merit awards are widespread in call centres, although just over one in five (22%) of employers awarded a pay rise to employees solely on the basis of their performance. A more common approach was to combine this approach as part of a wider reward strategy, for example by complementing IPRP increases with an across-the-board rise. Of course, the availability of appropriate measures should not be the only consideration when introducing PRP. Job design, and specifically, the existence of sufficient discretion in how jobs are done for employee effort to make a significant difference to performance, is critical. The relative routinisation of some, but not all, call centre work, may give employees little choice in how to do their jobs, thus reducing the possibility of PRP to have an impact on performance.

Segmentation

If IPRP works more effectively for some groups rather than others then it would be worth considering varying its introduction to suit the range of employee types. They can be grouped by grade – and it is common to treat executive pay, at least, differently from lower pay bands – or by occupation/function. Options for reflecting different approaches include:

- excluding some occupations or grades from IPRP altogether
- limiting the size of the IPRP budget for certain occupations or grades
- restricting the range of awards for specified occupations or grades
giving incentives in both base and variable pay for those for whom IPRP will work, but for other occupations or grades limiting performance reward to, say, just base pay. Where particular occupations or grades are excluded from IPRP or included in a restricted manner, consideration should be given to some form of compensatory reward, eg participation in team-based pay or in a recognition scheme.

Many HR practitioners (especially in the public sector) might recoil from such a variegated approach to pay because so much emphasis is put on fairness (that is in fact uniformity) and consistency that requires commonality. But if the point is to motivate staff, rather than to have standardisation, then the means should be chosen that has this effect.

Customer service roles

One of the early criticisms of IPRP was that a blinkered focus on the achievement of objectives harmed the quality of customer service. This is based on the premise that purely using outputs to drive pay is risky in that it can lead to inappropriate behaviours. But some customer service centres are overcoming this problem by incorporating both quantitative and qualitative aspects of service delivery into their PRP schemes, or combining merit pay with other forms of reward such as recognition schemes. A survey by the CIPD (2005) of reward in customer service occupations found that organisations with the highest levels of customer service used the following:

- individual performance-related pay
- performance judged against customer satisfaction, not just productivity
- team-based communication, reward and recognition schemes.

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The company’s corporate pay philosophy is to reward employees for superior performance. The core individual performance award is awarded on the basis of both quality and productivity criteria:

- ‘SOLVE’ - the quality of service the employee provides to the customer - connecting with the customer, exploring their needs, making a recommendation and delivering on the CPW Promise of service. This quality score takes a weight of 50% of the core bonus.
- ‘Adherence’ - adherence to the schedule which accounts for 25% of the bonus.
- ‘Not Ready’ - the time employees are not ready to take calls due to administration or note-taking tasks (25% of the bonus).

Those employees who achieve 100 per cent core bonus for six months also receive a ‘continual achiever’ bonus (IDS 2005a).
Sales roles

Turning to sales staff – Armstrong (1999) notes that the nature of sales means that rewards have been more results-driven than for other employees, with financial incentives typically forming a core part of their overall reward package. Variable pay, or ‘pay at risk’ has also been a key feature. However, this does not mean that PRP typically takes quite the same form for sales staff as for other employee groups, or that the same motivational theories underpin this form of performance-based reward. Performance targets for sales staff are often volume based, and their pay reliant, to differing degrees, on sales volume. However, Ryals and Rogers (2005) point out that selling is only a small part of the job for an increasing proportion of employees involved in the selling process and a growing number of account managers need to look after all of a customer’s needs (Suff and Reilly 2006). Therefore, the same issues affecting the relationship between customer service and PRP for call centre staff must be taken into account when designing appropriate pay progression strategies for sales staff.

Knowledge workers

Given the broadly accepted view that the UK has moved towards a knowledge-driven economy, there are implications for how ‘knowledge workers’ – first used by Drucker (1998) to describe an employee who adds value by processing existing information to create new information that can be used to define and solve problems – are rewarded. Of course, using this definition means that large sections of today’s workforce could be described as knowledge workers and, within this broad categorisation, it is important to differentiate the distinct groups of expert worker. There is a consensus that knowledge workers have a range of specific qualities and expectations of the employment relationship that set them apart from other workers. For example, research published by the CIPD (2004) found that they are normally ambitious, upwardly mobile and their key focus is career progression. In line with this finding, the researchers also reported that knowledge workers are not so much concerned with financial reward as with various non-financial rewards. For example, the opportunity to attend a conference, keep up-to-date with developments in their field, or undertake training was often highly valued and linked to getting full satisfaction from the job itself.

As a result, effective remuneration packages for knowledge workers tend to combine both financial incentives and non-financial reward and recognition practices in a ‘total reward’ approach. Financial rewards should comprise a mix of long- and short-term incentives: PRP in the form of bonuses for achieving a specific goal, for example, could give immediate impact and deliver immediate satisfaction, although there is a counter view that output-based incentive schemes may fail to engage knowledge workers. Thompson and Heron (2006) analysed connections between different dimensions of HRM and innovative performance for R&D employees in science and technology industries. They found that perceptions of PRP being delivered were positively associated with organisational commitment but negatively associated with innovative performance. However, this could be interpreted as innovative employees perceiving their performance-related rewards to be insufficient.
One of the biggest challenges in applying IPRP to knowledge workers is that the nature of their work can make it difficult to measure objectively. To use an extreme example, this may in part explain how PRP works for the sales force and not as well for research scientists – sales results are unambiguous, whereas research outcomes may be complex. Some organisations have included knowledge sharing or knowledge development as a specific objective under the performance appraisal process so that schemes refer to both inputs and outputs (Suff and Reilly 2005). For example, Cap Gemini revamped its performance review process to support knowledge sharing and all staff are assessed on knowledge management goals. Enterprise Oil also introduced a competency-based performance appraisal system and all staff had at least one objective relating to this area (IRS 2000). As with all staff, but particularly knowledge workers, attention has to be paid to developing good decision-making processes. Procedural justice (how decisions are made) is likely to be more important than distributive justice (how rewards are allocated). Financial rewards may be important in terms of how they convey status, but may not be sufficient to motivate or retain.

Continuing challenges

- **PRP delivers insufficient reward**

  A criticism that is often levelled at merit pay (and advanced, as we have seen, by equity theorists) is that, in times of low inflation or pay restraint, awards are too small to be motivational. Nearly three-quarters of respondents to the CIPD survey felt that performance awards – pitched at a median of 4% for non-managerial staff and 5% for senior managers – were too low to be meaningful as a motivator. Richardson’s evidence (1999) is that whilst three quarters of managers in his survey believed that IPRP improved organisational performance, their biggest problem was the small size of the award. US researchers have come to the same conclusion. Ed Lawler (1990) has made the point that merit pay is often too small to make a difference and, more positively, Appelbaum et al (2000) have claimed that where enough money is provided and reward is properly differentiated, merit pay systems are successful. The implications for organisations are not to rely too heavily on pay as a primary lever to motivate employees, since there will be times when they are likely to have insufficient resources to achieve satisfactory impact with financial reward.

- **PRP can damage creativity and intrinsic motivation**

  According to Deci and Ryan (1985), financial incentives demotivate the intrinsically motivated and, moreover, once the behaviour becomes linked to the reward, it is not performed without that reward. ‘Plans that are contingent on behaviour will encourage the prescribed behaviour and stifle initiation’, says Deci. Amabile (1998), supporting the view that PRP reduces creativity. However, others have suggested that these problems should not be over-exaggerated. For Jenkins (1998) the negative effects on task interest and creativity can be dealt with, whilst the positive effects on the quantity of output can be enjoyed. More boldly, George Baker has argued that plans that reward results are ‘likely to stimulate innovation’. A more nuanced position is that financial rewards
decrease intrinsic motivation in ‘high control’ cultures, but increase it in high
‘communication’ culture (Ryan, Mims and Koestner). This suggests that pay is a
supportive but not primary driver of organisational culture and that systems must be
developed taking into account other elements of the overall HR system.

■ PRP works well with top performers but not with the bulk of staff

This is the zero sum argument made earlier: whilst a minority benefits from PRP it is at
the expense of the majority. WorldatWork research suggested that in two thirds of
organisations PRP brought no change in employee engagement for average or low
performers. A better result was achieved, as one might expect, with the top performers
(57 per cent were more engaged). Such results lead some managers to mitigate the effects
of PRP by narrowing the differential between top and bottom. Indeed, Lynette Harris
has suggested that one of managers’ key objectives is to maintain trust and relationships
with staff, so IPRP is operated to maintain equity not reward high performers (2001). Of
course, one consequence is the problem described above – small increases for the best
performers.

■ Lack of employee support

As we have described, PRP is not so well accepted in the public sector as the private
sector. It can be argued that employees can recognise differences in performance and
may want to differentially reward those that contribute more. The problem is that either
they do not agree with management on what constitutes ‘good performance’ (perhaps
emphasising inputs over outputs) and/or they do not trust either the competence or
integrity of managers to make the right decisions. It is certainly salutary to record that
only 35 per cent of employees in a Hudson Survey believed that performance is more
important than tenure in determining their pay (Compensation and Benefits Review,
2005), and that half of managers in a Mercer survey believed that employees did not find
their IPRP schemes either fair or sensible. The same proportion felt that these schemes
brought little value to the company (Compensation and Benefits Review, 2003). Surveys
tend to find that employees overwhelmingly support PRP in principle but then
withdraw it rapidly when they see schemes operate in ways which they perceive are
unfair or deliver small rewards. Managing expectations about what PRP can and cannot
deliver is therefore a critical role for managers in the design and implementation process.

■ Is performance assessment without reward sufficient?

If at least some employees will not be motivated by reward, then is there an argument to
limit PRP to those occupational groups where a positive effect can be expected? Latham
and Locke’s research with lumberjacks and West’s research with the NHS suggest that
simply setting work goals and giving feedback on performance may be sufficient to
improve contribution levels. However, there is contrary evidence from Canada. A York
University study showed that those who received performance feedback and had a
linked reward were more satisfied with their pay than those who had no performance
appraisal or PRP not linked to appraisal.
Overcoming the challenges

Most of the available research – including that carried out by Kessler and Purcell (1992) – indicates that, where PRP fails, it is more to do with the scheme’s implementation and management than PRP per se. This is assuming, of course, that PRP is not regarded as a universal solution, is appropriate to the needs of the employee group and corporate strategy, is part of an integrated reward strategy that does not rely on PRP as the only motivator, and is not discriminatory. These issues should be tackled through the scheme’s design: reward needs to be segmented to ensure that the desired outcomes are encouraged to suit the particular needs of different employee groups, for example. For any reward scheme, there should be close congruence between organisational and employee interests, and a high level of trust in the competence and integrity of managers who are charged with making reward decisions. For PRP schemes, it is logical that bigger incentives are available for those employees where the largest variations in performance are possible.

But it is how PRP schemes are introduced and managed within organisations that will ultimately determine their success or failure. Armstrong (1999) identifies the following success factors necessary to make PRP work:

- define the objectives of the scheme
- ensure that the method of operation will, so far as this can be judged, achieve those objectives; account should be taken of the lessons provided by expectancy theory
- communicate the purpose of the scheme and how it works – transparency is essential
- involve as many people as possible in developing the scheme
- develop a comprehensive performance management process, again involving staff
- train everyone (staff as well as managers) in the skills and processes necessary to make performance management effective – this should include practice and training in objective-setting
- if the scheme includes ratings, define each of the levels as carefully as possible and issue guidelines on their application
- train managers in rating performance to ensure that they understand what is involved and gain familiarity with what the different levels mean by reference to real examples
- issue guidelines on how judgments on PRP increases should be made, whether or not ratings are used
- provide one-to-one tuition for managers on rating and pay-decision procedures
- monitor ratings and pay decisions against the guidelines and provide advice on dealing with inconsistencies or doubtful judgments.
Performance management

As Armstrong (1999) says: ‘You can pay for performance only if you can measure performance, and it is often difficult to apply appropriate measures that can be used fairly and consistently.’ According to him, the objective-setting and review processes associated with performance management can make at least as much impact on performance as PRP. Of course, not all PRP schemes rely wholly on performance against objectives, but which ever the basis for the reward, performance is being assessed in some form or another. An effective performance management system therefore lies at the heart of IPRP.

Over the past decade, a different concept of performance management has emerged, with an emphasis on ‘multi-directional and bottom-up involvement and performance improvement, rather than top down performance appraisal and control’ (Brown and Armstrong, 1999). Central to this approach is the idea that performance management should involve a continuous process of two-way discussion and development that seeks to increase skill acquisition, as well as reward the achievement of agreed objectives and contribution to business goals. Armstrong and Baron (2005) refer to performance management as a cycle that consists of a series of interconnected but not necessarily successive processes which take place throughout the year and which overlap – such as performance planning, defining expectations, objective-setting, reviewing performance, providing feedback, assessing performance and rating performance.

Case study
ScottishPower

A new pay structure based on job families and performance management was agreed for Scottish Power employees within its Energy Retail Division, a key driver of which was to recognise high performance. Annual increases and pay progressions are based on individual performance, and integral to the new system is the introduction of a new performance management framework that establishes an explicit link between performance and pay. Bedding down of the new performance management scheme is regarded as a crucial element of the new integrated pay arrangements. The performance management process is based on quarterly reviews, and a final annual performance appraisal. Objectives and associated priorities are jointly determined and agreed at the beginning of the performance management process. All objectives are set using the SMART (specific, measurable, achievable, relevant and timebound) criteria. These objectives provide the framework of measurable performance standards for individuals to work towards within the agreed timescale. Objectives should be reviewed regularly to ensure they remain relevant and may need to be changed by agreement to reflect changes in the working environment and business priorities. The aim of the quarterly reviews is to ensure that individuals are provided with adequate feedback on their performance, with a review of objectives. The annual performance appraisal incorporates: a review of previously agreed objectives, taking into account any changes in circumstances during the review period; a review of performance against agreed objectives; an agreed rating; the drawing up of a development plan; and the setting of objectives for the following year (IDS 2006).
Transparency and communications

According to Brown and Armstrong (1999), the clarity and communication of scheme objectives, generally linked to business strategy and goals, were found to be a key differentiator between successful and unsuccessful performance pay schemes. Transparency and communication are golden principles for the successful implementation of any reward scheme – but in PRP schemes, where some individuals receive higher awards for superior performance, the importance of communicating the right messages to employees cannot be emphasised enough.

**Case study**

Yorkshire Water

Yorkshire Water overhauled its PRP system and performance management process following employee and trade union perceptions that it was unfair and, according to the Unison official, was used, by managers as a ‘big stick’ to punish employees who stepped out of line during the year. The company also undertook research revealing that the distribution of awards was skewed in favour of higher-paid staff. As well as aiming to increase motivation and be affordable, one of the main goals of the new system was to be trusted by employees. The new scheme was developed and refined by a number of working groups, including trade union and employee input. Yorkshire Water established a separate team to manage the communications process prior to the new scheme’s introduction. It concentrated on a number of key messages, initially explaining why a performance management system was necessary. A number of media were used, including internal publications, team briefings and roadshows and two-hour joint trade union and management presentations to all staff prior to the roll-out. As a result of the joint communications effort, the Unison official says that employees now fully understand the company’s pay arrangements. To ensure fairness and transparency, the company publishes the size of quarterly bonus payments in advance and objectives are agreed jointly with employees in advance. The company is keen to ensure there is a clear line of sight between an employee’s performance in any particular quarter and the receipt of the bonus (IRS 2005).

**Case study**

Airbus UK

In 2005, Airbus UK introduced a revised pay and grading structure for technical and professional staff in its aircraft engineering and wing assembly plant. A major objective of the revised scheme was to devise a new set of arrangements which would reward good performance and relate pay to the market, at the same time as meeting union members’ concerns over fairness, consistency and transparency. Under the previous, merit-based scheme, the unions had come to oppose the merit budget on the grounds that the decision to award merit increases was subjective. As a result, no performance increases had been allocated since 2001. Before drawing up its proposals, the project team undertook a significant amount of research and visits to other companies to seek their views - all those visited emphasised the importance of communication and training to ensure that any new
Role of line managers

A key element of the ‘ideal PRP model’ is that responsibility and ‘ownership’ of the payment system should be devolved to line managers. But Armstrong (1999) says that PRP puts much greater pressure on line managers to possess and exercise skills in agreeing objectives, providing feedback, conducting performance reviews, and rating or assessing performance. If these tasks are carried out badly, PRP is likely to demotivate employees because they will perceive it as being operated unfairly and inconsistently by incompetent people. According to the CIPD (2007), one issue that has been a constant refrain for a number of years is concern over front-line managers: Do they have the attitudes, skills and knowledge to manage performance-based awards? ‘No, if you ask many pay professionals’, says the CIPD. According to its research, most front-line managers support the proposition of differentiating reward according to individual or collective performance – what those front-line managers have problems with is that the performance management and reward process is often developed ‘in splendid isolation’ by the HR department. The process of rewarding performance is something that is therefore done to, rather than done with, line managers. The implication of this is that it is more effective to design reward processes around the capability of line managers, involving them in the design and in the associated education and communication programme, rather than imposing the policy and required training on them.

Just as the efficacy of a PRP scheme typically depends on the supporting performance management system, so the performance review framework is only as effective as the line managers who operate it on a day-to-day basis. The need for mutual trust between appraiser and appraisee is crucial: the individual being reviewed is unlikely to provide a candid assessment of their own performance unless they trust their line manager not to take advantage of their honesty. Where the appraisal outcome influences reward decisions, as is often the case for IPRP, there is always the temptation for individuals to overestimate their performance, placing the line manager in the uncomfortable position of having to scale back the appraisee’s assessment (Suff 2001b).

Organisations implementing IPRP need to pay particular attention to the competence and confidence of line managers in dealing with difficult performance issues. As well as having the training framework in place to ensure that line managers understand and are committed to the performance management process, organisations operating IPRP need to make sure that these guardians of the system are able to differentiate between different levels of performance and are able to provide feedback. Line managers need to have the ‘softer’ management skills in order to convince people that their pay decisions are fair and unbiased. According to Armstrong (1999), by all means devolve as much accountability to managers for making performance pay decisions as possible, but provide reasonably close help and guidance, and involve managers in developing PRP to ensure ownership.
## Case study

**Rail Europe**

Rail Europe has operated a PRP system for over five years. All employees go through performance reviews to achieve a performance rating and this rating determines any pay increases for the coming year. Line managers conduct reviews for their own teams, and to ensure consistency, all managers then discuss all employee ratings with their own line manager. The key to the PRP process is, in the HR adviser’s view, consistency. In her view, some employees will always think that they are performing to a higher standard than they actually are. Alongside this, one manager will have a different view to another on what constitutes good or great performance. Therefore, the HR manager and call centre manager sit down and go through each individual award to ensure consistency (IRS, 2006e).
Conclusions

Performance-related pay is now a firm fixture of many organisations’ reward strategies and, in the right circumstances, it can form an effective motivational tool. But PRP is not a ‘quick fix’ and will not, on its own, act as a lever to improve individual performance and organisational effectiveness. If PRP is to be used to best effect, organisations need to reflect on those situations where it does have the potential to enhance employee motivation and improve productivity. PRP tends to be more appropriate for roles – such as sales staff – that lend themselves to the measurement of outputs. It may be difficult to apply objective-based PRP to knowledge workers, for example, many of whom work on long-term projects that do not necessarily have obvious, quantifiable outputs. This makes the setting of objectives and the assessment process challenging, and differential awards may be difficult to justify. With the quality of customer service now frequently forming the key differentiator for competitive edge, there is greater acknowledgement that how the job is done is as important as the achievement of objectives. The assessment of competencies, as well as the achievement of performance targets, provides a more rounded view of an individual’s contribution to business goals. Thus, many organisations now assess performance on the basis of both inputs and outputs, reflecting the move to contribution-related pay.

Any reward approach needs to acknowledge that individuals tend to be motivated by different things: remuneration arrangements therefore need to be tailored to meet individual differences as far as is possible. There is a greater recognition today that ‘money is not the only motivator’ and, for many workers, the job itself and elements, such as teamwork, career progression, good communications and recognition can engender longer-lasting levels of engagement and commitment. This applies, in particular, to public sector workers where it can be problematic to apply IPRP. Aside from the more theoretical objections – for example, that paying for performance goes against the grain of the public sector ethos – it is not straightforward to set clear targets given the potential political implications for some groups of public sector workers.

Where money is used as a key motivational tool, there should always be a clear line of sight between the effort expended by the employee and the financial payment. A particular problem with IPRP is that, at times of low inflation, the award is not
significant enough to effectively motivate people, and with the public sector pay restraints, this makes an incentive-based PRP scheme more difficult to achieve.

IPRP puts considerable pressure on line managers to manage and assess performance: where IPRP fails, it is usually more to do with the scheme’s implementation and operation than its design. Critical success factors include the need for clear objectives, transparency, good communications, an effective performance management system, and training for everyone but especially line managers. The CIPD has expressed concern that most front-line managers lack the skills and competency to manage performance-based awards. It is essential that line managers are competent to differentiate reward according to individual performance levels, and are able to foster an employment relationship with their staff based on mutual trust. This understanding will set the context within which discussions over performance, including under-performance, can be conducted in a positive way. If not managed properly, there is a real risk that IPRP will demotivate people who have over-estimated their own level of performance. Line managers therefore need to be involved from the inception stage of any PRP scheme if they are to ‘own’ it and if the scheme is to be suited to their capabilities as managers.
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