Pay-for-Performance (Incentive Pay)

A position paper from the TWC Consulting Group Inc

<u>Be careful what you pay for – you might not get it</u>

Pay-for-performance does not create or improve performance, nor does it help to attract or to retain top talent.

We know that this statement constitutes Heresy, and in the olden days, we would be burning at the stakes, but this is the 21st century so let's look at the evidence.

A few years ago the city of Albuquerque, New Mexico, faced a problem with its garbage collection. The truck crews were not completing their assigned routes on time, landing the city with a huge bill for overtime pay. Believing in the power of financial incentives, the city hit upon a plan: pay the drivers for eight hours regardless of how long it took them to complete their routes, figuring that this strategy would highly motivate the crews to accomplish their tasks quickly.

Strangely, when presenting this case to audiences in development programs, few had problems with guessing what the actual outcome of this 'incentive pay' was.

First, drivers found they could finish faster if they did not bother to pick up all the garbage on their routes. Unfortunately, however, people whose pickups were missed would call the city, which would then have to send a truck to pick up their trash, not exactly a cost-effective process.

Second, drivers could finish their routes more quickly if they sped. But speeding causes accidents, and the city soon found itself to be paying out more money in accident claims.

Third, the garbage collection teams could cut some time if they did not go to the dump to drop off their loads as frequently; but this decision led to them driving the trucks over the legal weight limit and receiving fines when they arrived at the dump. In 2002, 15 of the 24 drivers with the highest incentive pay brought overweight trucks to the landfill most often.

All of these added expenses wound up costing the city dearly, according to a grand jury that looked into why Albuquerque's apparent solution to its garbage collection-cost problem—instituting incentive pay—wound up being more rather than less expensive.[1]

Our starting premise seems to be very much at odds with what is happening with pay the world over, where individual incentive pay, including commissions for salespeople, is so tremendously in fashion these days.

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Hewitt Associates, a compensation and human resources consulting company, reported that, in 1991, 51 percent of the companies participating in its salary survey offered at least one plan that tied pay to performance, a proportion that had increased to 77 percent by 2003.[2] This trend is not confined to the United States: a 2003 Hewitt survey of 115 organizations in Canada found that 81 percent had some form of pay for performance, up from 43 percent in 1994.[3]

Even in Continental Europe, Korea, and Japan, where individual pay for performance was historically much less prevalent, there seems to be inexorable pressure to copy the United States' example and introduce more individual, performance-based incentives. For instance, executives from Hanwha, a large Korean conglomerate, described the pressures they felt to adopt more individual pay for performance. Researchers from Recruit, a Japanese human resources and publishing company, also told about the growing belief that individual pay for performance should be adopted by Japanese companies, even as their own studies showed the problems with moving in this direction.

Strangely enough corroborative evidence has yet to be found that links this avalanche to sustainable improved corporate performance.

So, what-the-Dickens is going on? Apart from this, again, resembling a strong case of 'Lemming Leadership'*?

Well, at gut-feeling level, pay-for-performance or incentive pay does not sound such a lousy idea: we dangle an extra amount of money in front of people to meet or exceed certain performance targets. Sounds okay? – Sorry, no, it does not, it sounds dreadful and extremely cynical.

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At issue here are three things, 1) managing performance in people, 2) finding a just financial compensation, 3) finding the right level of remuneration to attract and retain people with the required behavior and competencies.

Now, allow us to be real blunt. The pay-for-performance approach, besides the cynical view that people need bribes to perform, looks to us mightily like some Government's approach to crisis management 'if we just throw enough money at it all the problems will disappear'.

As there is no empirical evidence that incentive pay increase performance it would seem wise to examine the underlying issues rather than employ a gut-feeling quick fix.

[1] "Garbage Truck Drivers Rushing to Finish Routes Are a Safety Risk" Associated Press, January 30, 2004.

[2] "Trends in Incentive Compensation" Hewitt Associates, June 2004.

[3] "Christmas Bonuses Give Way to Incentive Pay" Edmonton Journal, November 28, 2003

* "Of Leaders and Lemmings" Position Paper, TWC Consulting Group, July 2008 ed.

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An unfortunate outside facilitator in the form of an increasing trend of measuring people performance as compliance with goals/targets/KPIs plays into the hands of pay-for-performance advocates – its pseudo-scientific construct allows for seemingly mathematic correlation.

Now, allow us to propose an alternative scenario

First, let us look at performance at people level. Organizations employ people to perform a set of processes.

Once we accept that definition, performance becomes relatively clear as the ability to stabilize the processes; the ability to improve existing processes; and the ability and understanding to innovate on deliverables and subsequently to design new processes, creating these deliverables. These three areas we can manage successfully and sustainably without ever resorting to the involvement of either goals/targets/KPIs or money.

Second, let us look at pay (salary).

Salary should be fair and perceived as fair. The basis also should be transparent not the least to, among other things, allow people to see objectively what is necessary to receive a higher pay. We strongly believe people should be paid according to a) the competencies they possess in relation to the competency requirements of the job they hold, b) the competencies they possess complementarily to the job and c) the competencies they possess to manage themselves as whole persons. Salary calculated along this framework easily presents itself as fair and transparent.

Third, looking at a remuneration environment able to attract and retain people with required behaviors, desired traits, and competencies, we will have to go beyond mere money. Even though a fair salary (money) is a necessity, this alone does not suffice to attract and retain the right talent. The whole organization culture has to meet the expectations of the talent in question: non-financial elements of remuneration, job satisfaction, meaningful assignments, organization vision, values, reputation, etc.

If you believe people just care about money, think again, or pay at your own peril.

We know that we postulate a radical departure from current trends and thinking, but we strongly suggest following gut-feeling with care, it may lead to indigestion.