Doing More With Less:

Paying for Performance in the New Economic Reality

The "great recession" of 2008-2009 has resulted in unprecedented cost-cutting actions for most organizations — especially cuts related to compensation. The issue of how economic conditions have impacted overall compensation costs (and how to effectively manage those costs) has painted 2009 and 2010 as a period like no other in recent memory.

To help companies best align pay and performance so employers and

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employees benefit, this article explores the traditional way companies have paid for performance through salary budgets, why this will no longer be effective in the new economic reality and how to improve it.

**Salary Budgets, By the Numbers**

Based on data from Hewitt Associates’ *Salary Increase Survey*, for both 2008/2009 and 2009/2010, Figure 1 shows how planned salary budgets progressively shrank from the start of budget projections (July 2008) to the point that actual 2009 budgets were reported (August 2009).

The final salary budget numbers for exempt salaried employees for 2009 are by far the lowest seen since 1976, when Hewitt started the survey. However, shrinking salary budgets are not new, as Figure 2 shows. Through the years, compensation professionals have had to deal with the reality of using fewer salary increase dollars to reward employee performance. And that has never been a more glaring challenge than now, when salary budgets have tanked below 2 percent of payroll, a low watermark that most thought they would never see.

While the 2.7-percent projection for 2010 is better than the 1.8 percent we saw in 2009, there are very few prognosticators who believe salary budgets will go up much beyond 3 percent for the foreseeable future. As a result, the question that has dogged many for the past few years is even more relevant now that there is so little salary increase budget left: How do you continue to pay for performance using the traditional method of salary increases in this new economic reality?

**The Traditional Way: Salary Budgets and Merit Pay**

Most American companies (and many companies globally, as well) find themselves slaves to the traditional pay-for-performance process. At the end of the fiscal year (or some other performance period), managers conduct performance reviews for their employees and decide on a pay action (almost always a salary increase, but sometimes a variable pay award also) related to that review. While a worthy and necessary process, it is often stymied by a merit budget that progressively limits managers’ ability to differentiate performance.

In fact, 2009 might be called the year when merit budgets finally revealed themselves to have very little to do with merit. The Hewitt survey found that of the 1,144 U.S. companies that participated in the 2009/2010 survey, 48 percent had no salary increase budget (which consists of merit as well as other things like promotional increases and market adjustments) for a portion or all of their employees. In the 33 years of conducting the study, this result is unprecedented. In fact, in most years, the number of organizations that report no salary increase budget is around 2 percent to 3 percent — hardly worth noting.

Note that even for those organizations that did provide funding for salary increase budgets, more employees than ever received no increase. The results from the Hewitt survey — the line graphs in Figure 3 — show that for

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**FIGURE 1: SALARY BUDGETS — THE 12-MONTH MARCH DOWNWARD**

- **July 2008 Projection**: 3.8%
- **October 2008 Projection**: 3.1%
- **December 2008 Projection**: 2.4%
- **Actual 2009 Budget**: 1.8%

*Source: Hewitt*

**FIGURE 2: THE INCREDIBLE SHRINKING SALARY BUDGET**

- **1990**: 5.5
- **1991**: 5.0
- **1992**: 4.6
- **1993**: 4.3
- **2000**: 4.3
- **2001**: 3.6
- **2002**: 3.4
- **2003**: 3.7
- **2008**: 1.8
- **2009**: Projected 2.7

*Source: Hewitt*
companies that paid salary increases, the number of employees actually receiving an increase was the lowest in five years. While this appears to be good news for differentiating pay, the bar graphs in Figure 3 paint a different story. They show that while the average high and the average salary increases reported by companies in the survey have dropped fairly significantly in the past few years, the reported average low increase has remained steady, even as salary increase or merit budgets have shrunk.

While there is not hard evidence that the best-performing employees also received the highest increases in the Hewitt survey, it is a reasonable assumption that the average high reflects the type of increase organizations give their best-performing employees. That suggests that along with providing no increase more frequently than ever, organizations also awarded less money to their best-performing employees, which may or may not have been avoidable.

In any case, the dramatic conditions for rewarding performance using merit budgets in 2009 may have a silver lining — smaller budgets force organizations to consider how to best use their scarce salary increase funds. In other words, the new economic reality encourages a true examination of whether, as well as how, pay drives performance.

**Why Doesn’t Pay for Performance Work?**

Before examining the pay-for-performance equation, it is important to understand why traditional methods of pay for performance haven’t worked very well in many organizations. Besides progressively smaller salary increase pools,
organizations experience other barriers to effectively linking performance and pay. Those on the performance management side of the equation say the process is flawed because the pay limitations taint the performance discussion. For example, when managers tell employees "You're a really good performer, but due to our performance distribution guidelines (which are very often driven by the salary budget), I have to rate you in the middle," the often valid criticism is that this seems like "the tail wagging the dog" — isn't the performance rating supposed to drive the pay decision rather than vice versa?

While the performance rating in and of itself seems like a valuable assessment tool, put these ratings together in a performance distribution curve as a relative measure and the fur starts to fly because the distribution curve typically shows how effectively (or ineffectively) an organization is differentiating performance for the purpose of rewarding it. One of the biggest issues here is illustrated in Figure 4, which shows Hewitt's High-Performance Workforce Rating Guidelines, and in Figure 5, which shows the performance rating penalty. A reward system intended to make leading performers — the people an organization can ill afford to lose — feel special can present an unintended consequence for strong performers, who represent the majority of employees and are the backbone of the organization. A strong performer (Employee A in Figure 5) just misses going...
into the leading performer category and, therefore, given salary budget guidelines, receives a very different salary increase than the employee lucky enough to just make it over the leading performer line (Employee B). The end result is a process that often causes more disengagement issues than it may seem worth given all the resources and effort that go into it.

Dissecting Pay for Performance: Inputs and Outcomes

To further examine why pay for performance may not work, especially given today’s economic reality, it is important to note that with the traditional approach of using mostly salary increases and sometimes variable pay to link to a performance rating, we often define performance too broadly and pay too narrowly to help managers make the right decisions.

Using performance inputs, managers determine how to reward for those inputs with reward outcomes, which can include financial and nonfinancial rewards. However, organizations often direct managers to consider all elements of performance to come to a reward decision, and the reward options are almost always narrowly focused on salary increases and (sometimes) variable pay awards. Such performance inputs as whether the employees performed the job as expected, or how they achieved specific, quantifiable goals, or whether they have the potential to advance to another job or take on tasks beyond their current job can all be defined more specifically in order to better direct the manager on which rewards (beyond the traditional ones) align best with these different facets of performance.

Through greater dissection of performance inputs and equipping managers to use the full range of reward outcomes, organizations can get on the road to improving how pay for performance works and possibly have a more highly engaged workforce.
Conclusion. Additionally, even the organization with a salary budget under 2 percent can make paying for performance more effective by widening the scope of pay to include other rewards, such as variable pay, special recognition awards and even more nontraditional elements, such as supplemental paid time off (PTO), flexible work arrangements or development opportunities.

The Pay-for-Performance Discussion

Many managers consider pay-for-performance discussions a waste of time. This is not surprising, given the historical frustrations with the pay-for-performance process. But provided with more guidance, managers could translate performance inputs into relevant reward outcomes, and these conversations would have much greater value and relevance. The greater transparency helps employees understand not only what they must do to earn the financial rewards they desire, but how to continue to develop and grow in their careers. In the new economic reality, many organizations are finding that employees desire this long-term career-growth perspective, often as much as cash awards. Employees frequently recognize this as their ticket to building value and greater rewards over time and, as such, organizations are discovering that this results in greater engagement and increased productivity.

Note that given the overall importance of these discussions, it is better to err on the side of providing managers with more direction than less. This may mean dissecting performance inputs and aligning them with pay outcomes as well as giving managers suggested scripts and making the pay-for-performance discussion a requirement.

Making the Case for Performance-Driven Total Rewards

Broadening the range of pay outcomes leads to an interesting notion that many elements in the total rewards offering, as shown by the WorldatWork Model in Figure 7, can and maybe even should be tied directly to individual performance. But as traditional compensation dollars in the form of salary increases shrink, and given that bonuses are often impacted by financial performance, do not recognize individual performance or have broad eligibility, how does an organization retain its best performers?

A fresh look at the link between performance and total rewards forces us to challenge our deep-rooted assumptions that cash compensation is a prime motivator for all employees at all times. There are some classes of rewards that Baby Boomers and Generation Y members rate at least as important as cash compensation, according to research in the article “How Gen Y and Boomers Will Reshape Your Agenda” in the July-August 2009 issue of Harvard Business Review by Sylvia Ann Hewlett, Laura Sherbin and Karen Sumberg. A few examples of these

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<th>Performance Inputs</th>
<th>Pay Outcomes</th>
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| **Expected Job-Based Performance**<br>“Are you doing the job as I expect?” | • Continued employment  
• Base salary increase (aka merit increase)
• Continued vesting toward benefits  
Equity (maybe)
• Job-related training/development (maybe). |
| **Above/Beyond Expected Job Performance**<br>“Wow, you’re doing things that I had not expected for this job!” | • Additional base pay increases — promotional or other  
Equity  
Special recognition  
Development opportunities. |
| **Goal-Based Performance**<br>“What have you done for me lately?” | • Cash bonus  
Equity  
Special recognition  
Other noncash: supplemental paid time off (PTO), flexible work arrangements. |

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| Job defined at time of hire (or promotion/transfer), with anticipation that the employee will perform at an expected level. | • Continued employment  
• Base salary increase (aka merit increase)
• Continued vesting toward benefits  
Equity (maybe)
• Job-related training/development (maybe). |
| Exhibiting skills/competencies to do another job or a job at the next level | • Additional base pay increases — promotional or other  
Equity  
Special recognition  
Development opportunities. |
| Not tied to goals; not typically time-based. | • Cash bonus  
Equity  
Special recognition  
Other noncash: supplemental paid time off (PTO), flexible work arrangements. |

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FIGURE 6: EXAMPLE OF ALIGNING PERFORMANCE TO PAY
include flexible work arrangements, recognition from one’s company or boss and prospects for advancement. This is good news, as it suggests that there may be an alternative mix of rewards that are just as motivational to high and strong performers as providing more cash, which is untenable in the present economic climate.

As is the case with generational differences, this knowledge will mean abolishing a one-size-fits-all approach. Using the WorldatWork Total Rewards Model, for example, we can envision taking different rewards from the benefits and work-life elements to tie to individual employee performance, just as we have always done with the traditional rewards elements of compensation (i.e., merit increases and variable pay).

**Putting It All Together: Creating a New Approach**

By better defining the performance inputs to more effectively align them with the traditional pay outcomes as well as the broader total reward offerings and tying them directly to what individual employees specifically value, organizations can create a new approach to paying for performance. This approach can ease economic pressure on traditional pay elements and the frustration of managers and employees who sit down for the all-important pay-for-performance discussion.

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