

# Why Performance Based Pay Is Important For Every Organisation

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Choosing the correct method of [compensating your employees](#) while running a business will play a critical role in the overall performance of your organization. One type of additional compensation you might use to help empower your workers is the performance-based pay on results. Performance-based pay schemes have become more widespread in recent decades. The hope is that such [financial incentive schemes](#) boost firm productivity, revenues, and profits; firstly by incentivizing existing employees, and secondly by encouraging the high-performing employees to apply for and stay in jobs.

## What is performance-based pay?

With this method of compensation, employees are paid depending on their performance level and thus [individual performance](#). This could also be referred to as a compensation pay structure in some cases. There are different types of [payment schemes](#) that apply to performance pay systems, which are designed to distribute financial rewards to employees. In contrast with set salaries, performance pay is based on compensating the employee per their contribution, not the value of the position itself. In other cases, the employees may be paid based on how many units they produce or perform in some other statistical category.

In this competitive environment, many organizations are turning to variable pay programs to keep top recruits' and [top-performing employees'](#) pay competitive with the market (Harrison, 2019). Whereas salary increase budgets have remained flat at 3% for the last several years, data from Salary.com's Pay Practices and Compensation Strategy Survey (2019), shows that many firms are adding budgets to their variable pay programs. According to our survey, the percentage of organizations committing at least 10% of their payroll budget towards non-discretionary bonuses and discretionary bonuses has more than doubled since 2017, while the percentage of organizations committing less than 3% of their total payroll budget to such programs has diminished over time.

## Types of Performance-Based Pay Systems

There are two general categories of performance-based financial compensation: [merit pay](#) increases and variable pay programs (Harrison, 2019). Organizations that want to implement a performance-based pay

program can use either of these two types of performance-based pay plans – or both – to incentivize employee performance and to drive towards desired outcomes.

## 1. Merit Pay Increases

A merit pay increase refers to an increase in an employee's base pay due to high performance. These raises are typically delivered on an annual basis and are budgeted for as part of the annual salary increase budgeting process (Harrison, 2019). Merit pay increases are the most commonly used [pay-for-performance model](#) for recognition of employee performance, as they differentially reward top performers for their contributions with a bump to their base salary for the following year (Harrison, 2019).

However, according to Chris Fusco, the Senior Vice President of Compensation at [salary.com](#) (2019), the external market is progressing in pay faster than merit pay increases alone can match. This makes top performers in your organization a flight risk because they could potentially walk out the door just to take a job that offers more competitive pay (Salary.com, 2019).

## 2. Variable Pay Programs

Variable pay programs encompass a variety of discretionary and non-discretionary bonuses that can vary from employee to employee according to the payout period, the eligible employees, and the metrics that employees are measured against (Harrison, 2019). Unlike merit pay increases, variable pay programs are increasingly administered not just annually but multiple times a year (e.g., once a quarter), and a mix of different variable pay programs are often used in combination to achieve the desired results.

[Discretionary bonuses](#) are awarded on an ad-hoc basis to employees who demonstrate exceptional performance, often without consideration of pre-defined goals and objectives (Harrison, 2019). Some common discretionary bonus types are:

- Spot bonuses – Reward employees “on the spot” for achievements that deserve special recognition.
- Project bonuses – Reward employees for completion or superior completion of a specific project.
- Retention bonuses – Typically awarded to long-tenured employees, or employees in hot jobs, to decrease their flight risk.

**1. Nondiscretionary bonuses** are awarded when employees, teams, or the entire organization meets specific, pre-defined goals and objectives (Harrison, 2019). Based on the duration of the assessment period (the amount of time over which performance is measured), they are considered either short-term incentives (STI) or long-term incentives (LTI). Some common nondiscretionary bonus types include:

- Company-wide bonuses – these focus on specific improvement goals for the organization and reward employees based on how much improvement is made on these goals within a certain period.
- Team-incentive bonuses – these focus on specific improvement goals for one team (e.g., marketing or sales) and are rewarded based on performance for that team.
- Individual incentive bonuses – these plans are often based on predetermined, measurable business objectives (MBOs) that are evaluated periodically (e.g., each quarter) based on one person's performance

Of all the variable performance bonus types, individual incentive-based pay plans were the most popular, used by 53% of participants in our survey (Salary.com, 2019). An organization's pay-for-performance compensation strategy will likely include a combination of merit increases and short-term incentive plans.

## **Advantages of a performance-based pay system**

Performance pay offers a variety of benefits. One of the major advantages of performance-based pay is that it gives employees more reason to work hard and perform better. When an employee knows that he can be compensated more, he is willing to put more time and effort into his job. When you are paid on salary, you can only be motivated by that amount of money for so long. With performance-based competition, employees work harder and it ultimately rewards the company as well. Potential employees may be more likely to choose a company that offers monetary incentives in exchange for their good work performance, and therefore potentially higher salaries.

Also, management enjoys better employee performance and employee engagement. As long as there is a fair and effective performance review system that is accurately aligned with local salary levels, employees will strive to work hard. Executives will enjoy increased revenue and working capital. Management can use performance pay systems to transition model employees into supervisors. HR administrators can use performance pay to attract potential job applicants

and improve employee retention. In the beginning, turnover rates may be slightly higher as low performers leave, but qualified and motivated employees will remain.

## Disadvantages of a performance-based pay system

This form of compensation also has a few potential drawbacks. For example, when the business suffers for reasons outside of the employee's control, it may be harder to perform well. Sales may not come as easily and it can lead to lower paychecks for the employees. This form of compensation also leads to income gaps in society as a whole. Over the years, performance-based compensation has increased while the gap between wealthy and poor has grown. Part of this is because those with this pay structure earn more.

Furthermore, some companies struggle to implement performance pay systems because it is hard to define performance levels and objectively evaluate employees. The performance criteria and measurements may be vague and inadequate. As a result, supervisors favor certain employees over others, which increases collective employee dissatisfaction. When employees cannot understand the performance measures, they may still blame management when they fail to receive wage increases. Sometimes, the objective of [performance appraisal systems](#) is to merely identify training needs or promotion suitability. The biggest challenge of performance pay systems is that management must continually observe and document employee performance while also providing feedback, which is very time-consuming.

## What do research studies show?

In a 2010 joint Harvard Business School and Yale School of Management study on whether bonuses boost sales productivity within the sales force of a large office supply company, researchers found that:

- Bonuses do increase productivity.
- Quarterly bonuses increase sales force productivity more than annual bonuses.
- Salespeople tend to give up when they're far away from reaching a quota, but they don't slow down once a quota is reached, especially if their firm offers commissions for overachievement.

For non-sales roles, the data is equally compelling. More companies are offering short-term incentives, according to a 2018 report by WorldatWork, which surveyed 325 companies, non-

profits, and government organizations. The survey results showed that 96 percent of the responding companies had short-term incentive programs in 2017, up from 94 percent in 2015. Spending on short-term incentives rose to a median of 6 percent of operating profits, up from 5 percent in 2015. Also, about 66 percent of non-exempt employees were eligible for annual incentives, up from 52 percent. In the survey, 74 percent of respondents said their organization's annual incentive plan was “moderate to effective” in achieving its objective. That rating, along with the increase in the use of incentives, shows that compensation professionals find them successful.

Incentive pay, which is a variable form of additional compensation, can benefit business owners in other ways as well. “During volatile economic times, the use of variable pay allows a company to reward individuals and teams based on current profits and productivity, without the promise or expectation that such rewards will be offered continuously,” according to a 2014 article in the *International Journal of Human Resource Studies*. This can be observed in Zimbabwe which is currently experiencing volatility in its economy.

While this arrangement does have many benefits, there are also some downsides, according to a study published in the *Human Resource Management Journal*. The study looked at three different types of “[contingent pay](#)” performance-related, profit-related, and employee stock ownership, and how they affected employee attitudes such as [job satisfaction](#), commitment to the company, and trust in management. Here's what they found:

Only performance-related pay (in other words, pay based solely on the individual employee's performance) positively affected all three of these employee attitudes. Profit-related pay being arrangements related to company profit or employee stock ownership, either didn't affect employee attitudes or affected them negatively.

But even performance-related pay isn't all good. The study reports that although performance-related pay positively influenced workers' attitudes, it also tended to stress them out to a degree that might negate the beneficial effects. Employees in this type of arrangement are more likely to feel they're being encouraged to produce high-quality work, which decreases their job satisfaction. Ultimately, the stress can lower their productivity giving performance-based pay the exact opposite effect that was intended.

## **Making Performance-Based Pay Work**

This doesn't mean you should write off the idea of performance-based pay altogether but there is a need to take some precautions to make it work for businesses. Organizations can try these tips:

- Strike a balance. Try setting “stretch goals” performance goals that aren't easy to achieve, yet aren't so difficult that employees feel defeated before they even start. You could also set different bonus levels for different levels of performance so that not everyone feels they have to aim for the highest possible level.
- Make it proportionate. Don't make employees work incredibly hard for a small reward. It's important to ensure a balance between [employee job demands](#) and the reward, the study says.
- Pay attention. Regularly check in with employees and managers to see how your performance-based pay system is working. Do employees seem stressed and overloaded? Perhaps the bar is set too high.

In conclusion, the available evidence shows that performance-based pay schemes are indeed associated with significantly more productive employees. But the scale of the benefits varies according to the type of scheme. The most effective schemes are those that reward employees for individual effort, rather than group performance.

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