Many organizations know that pay should help drive individual and overall performance, but they struggle to connect pay with performance.

A study of best practices at Fidelity, Gillette, and Raytheon demonstrates that these gaps can be overcome.

Our six principles provide guidance for developing merit and incentive pay programs that reinforce key organizational and job-related objectives, motivate employees, and recognize outstanding performers in a meaningful way.
Bridging the Pay-for-Performance Gap

Establishing Truly Differentiated Rewards

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The Essential Elements of Effective Performance Management

Few activities can more strongly align employee behavior with business objectives than an effective performance management process. However, its inherent complexities and sensitivities have led many organizations to search for a “silver bullet” for addressing the challenges of managing individual, unit, and corporate performance. Through decades of consulting experience and extensive research—including our work with the FORTUNE World’s Most Admired Companies—we have identified the essential elements of virtually all successful performance management programs. These include:

- Creating Clarity Around Goals
- Building a Culture of Dialogue
- Establishing a System of Truly Differentiated Rewards

These elements are interconnected. Performance management systems and processes depend on clarity and commitment from the leaders in an organization. Candid and frequent dialogue on performance lets employees know where they stand and builds a foundation for improvement. Differentiated rewards, the focus of this paper, should reinforce behaviors associated with organizational and job-related objectives, motivate employees to achieve outstanding performance in their jobs, and recognize outstanding performers in a meaningful way.

The Pay-for-Performance Disconnect

Many organizations know that pay should help drive individual and overall performance, but they struggle to consistently connect pay with performance. The result sends mixed messages to employees, demotivating some and reinforcing an unacceptable status quo with others. The disconnect can span all elements of an overall pay program but is most pronounced on the cash components including merit—defined as the annual base salary increase—and the annual incentive pay program.

1 For more on this subject, please refer to Hay Group’s working paper “Managing Performance,” which can be found in Research & Opinions on haygroup.com.
Pay is extremely important to the individual and the organization. Research by Hay Group Insight, our employee opinion research division, reveals that compensation is the primary reason for voluntary attrition among high performers (see Figure 1).

**Figure 1: Reasons for Voluntary Attrition**

The loss of high performers is extremely costly and disruptive, including direct replacement expenses (e.g., advertising, search, and “on-boarding” new hires) and indirect opportunity costs (e.g., lost sales, lower productivity, and customer defections). Beyond retaining high performers, pay programs have the potential to align and focus employee behaviors to achieve essential operational and strategic objectives. As a result, organizations invest tremendous amounts of time and money to design, administer, and deliver competitive pay programs for their employees. In many cases, compensation and benefits are among the largest expenses on an organization’s income statement.

But unlike a capital project or a financial vehicle, the return on an additional dollar of compensation investment—the “incremental” investment—is difficult to measure. Few organizations are convinced that they are getting an adequate return. Over the past two years, Hay Group has conducted research with WorldatWork and Loyola University of Chicago into the perceived effectiveness of reward programs. Nearly 40 percent of respondents felt that they did not get an appropriate return on their annual incentive pay investment, and fewer than 10 percent described their merit pay programs—annual increases in base salaries—as “very effective.”

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3 For more on Hay Group’s research with WorldatWork and Loyola University of Chicago, please see “Linking Compensation and Organizational Effectiveness” in Research & Opinions on haygroup.com.
Employees are similarly skeptical about the link between pay and performance. An employee attitude survey conducted by Hay Group Insight at 335 companies worldwide found that only 35 percent of employees said they believed they would earn more if they improved their performance (see Figure 2).

Figure 2: If my performance improves, I will receive better compensation.

Bridging the Gap: Challenges and Alternatives

Given the importance of pay, why do both organizations and employees feel that there is such a disconnect between pay and performance? Our experience points to five leading factors:

- The Limitations of Merit Pay
- Overlapping Objectives
- Inadequate Differentiation of Performance
- Inadequate Differentiation of Rewards
- Misalignment of Effort and Resources
**The Limitations of Merit Pay**

Many organizations try to reward performance through their merit pay programs. But economic influences and internal equity corrections limit merit pay’s effectiveness as a pay-for-performance vehicle.

Rather than being solely based on an employee’s performance and pay relative to market, merit increases are heavily influenced by an organization’s overall salary budget. This, in turn, is influenced by industry conditions and general economic factors, such as the unemployment rate. In effect, employees expect a salary increase each year that is at least the size of the average salary increase budget. As a result, wage inflation consumes merit pay budgets.

The merit budget is further diluted by corrections for internal inequities, such as pay compression between supervisors and subordinates. Most organizations would like merit pay increases to move top performers’ salaries higher while keeping low performers at the bottom of the pay ranges. But in many cases, the reverse happens. Long-tenured low performers penetrate the top portions of salary ranges while high performers change jobs so often that they never penetrate the ranges at all.

The bottom line: too much of the merit pay budget is consumed by cost-of-living and internal-equity adjustments and not enough is left over to effectively pay for performance.

**Fidelity—Making Merit Pay Work**

Fidelity Investments is the world’s largest mutual fund company and has aggressively expanded into providing a full breadth of financial services to individuals and institutions. To maintain their position as the “Employer of Choice,” they have developed an innovative compensation philosophy focused not only on differentiating performance, but also on differentiating rewards.

Fidelity maintains separate budgets for merit increases (which are not driven by positions in a range) and equity adjustments (which are tied to market rates). Merit dollars are provided to eligible employees who consistently exhibit exceptional performance and who uphold and model Fidelity’s values as they achieve results. In general, top performers are funded at the expense of lower performers and non-performers. In fact, even average performers generally get less than the average salary increase budget number, which can pose a communications challenge for managers at times.
Overlapping Objectives

Many organizations confuse and overlap the objectives and measures of their merit pay and incentive pay programs. As a result, organizations pay employees multiple times for achieving the same outcome, thereby diluting the funds available to really motivate and align efforts. The lack of clarity around objectives and measures also affects employees, who run the risk of misinterpreting the outcome. Fidelity sends a clear, strong message to their employees, reinforced by the separate evaluation processes and payout periods.

Fidelity—Clarifying Merit and Incentive Pay Program Objectives

For most of Fidelity’s business units, total cash is positioned above market relative to the competitive landscape. However, they reinforce strategic objectives and reward outstanding performance by separating many of the traditional compensation elements. For example, they determine merit increases (which emphasize overall performance and development in a role) separately from bonus goals (which emphasize performance against pre-established targets). They further reinforce this separation by initiating merit increases in July and paying bonuses in December. This ensures that they are not paying for the same things twice.

Inadequate Differentiation of Performance

Organizations have a tough time meaningfully differentiating performance. It is a cruel irony when most employees exceed expectations yet the organization’s overall performance flounders.

There are some interesting parallels between managers and parents. Just as few parents would admit that their children are “below average,” managers exhibit a similar tendency with their employees. While we would expect performance within a given group to represent a normal distribution, the performance curve is often skewed to higher ratings because managers lack the will or the know-how to properly evaluate their employees’ performance.

Mechanical differentiation isn’t much better than poor differentiation. When the focus is on forms and ratings scales, managers focus too heavily on the process and bureaucracy and not enough on counseling and developing their people. The result is largely window dressing.
Raytheon—Beyond Mechanical Differentiation

Raytheon is an engineering and defense contractor with over 78,000 employees. In 1998, the company hired Dan Burnham, formerly of Allied Signal, as CEO. At Raytheon, Burnham hired several former GE executives, including a new Head of Human Resources.

HR introduced and drove many GE-style talent management programs, such as performance management. This included cascading business goals to align individual goals with business metrics, publishing business results, providing performance feedback to employees, and giving “highly differentiated rewards” based on performance. Although these programs achieved dramatic change in short order, many leaders and employees believed the program was overly mechanical, focusing too heavily on assigning ratings and achieving the program metrics and not enough on dialogue and development. While performance rating distributions improved and rewards were highly differentiated statistically, the change initiative became increasingly disconnected from its intended impact on the goals, performance feedback, and development of individual employees.

When Bill Swanson became CEO in 2003, he immediately began to improve the alignment of assessment, rating, dialogue, and rewards within the performance management process. He began by cascading goals earlier and ensuring managers had the skills to adequately assess performance and communicate with subordinates. Furthermore, he drove this initiative from his executive team, with HR helping his leadership team to model the correct behavior and achieve consistency among assessment, rating, development actions, and feedback for their business leaders. The leaders then modeled and cascaded this improved process throughout their own organizations.

Inadequate Differentiation of Rewards

Even when organizations achieve differentiated performance, they still struggle to translate this into differentiated pay.

Higher performers deserve the highest rewards, and organizations need to have the courage not to spread incentive pay like peanut butter—that is, evenly over the organization. This is essential, even when an incentive program receives adequate focus and funding. Similarly, they need to have the courage to pay lower performers lower incentive pay—if anything at all. Unfortunately, many managers would rather settle for mediocrity than make waves in their department or have difficult conversation with a low performer about why they did not receive an incentive payout. As a result, the message isn’t strong enough to motivate and align employees.

Gillette—Differentiating Performance and Rewards

Jim Kilts left Kraft in 2001 to become the CEO of Gillette, which was floundering and had lost investor confidence. Kilts developed a new Strategic Growth Plan (SGP)—a roadmap for financial and strategic turnaround as well as functional excellence.
The “functional excellence” component of the SGP surprised many employees. Gillette had a tradition of hiring the best and the brightest from top business schools and promoting from within. Furthermore, almost 60% of Gillette employees received “exceeds” performance ratings and were paid bonuses as a percentage of their base salary—profit sharing rather than paying for performance. Everyone thought they were high performers while the company chronically underachieved. Under these circumstances, the best and the brightest stagnated.

Kilts implemented a performance management program that differentiated both performance and rewards. Corporate performance determined the overall bonus pool, which was allocated to functions and business units according to their relative performance. Finally, individual performance was measured on a five-point scale and based on achievable stretch goals clearly linked to unit and company objectives. Kilts drove the program, which he also applied to his own executive team.

In the three years since implementation of this program, the number of employees “exceeding” expectations has dropped from 59% to 24%, and the stock price has grown annually by over 16%. By bringing some outside perspective and a serious commitment to paying for performance, Kilts has lived up to his reputation as a turnaround expert.

### Misalignment of Effort and Resources

Organizations do not often allocate their investment of time and resources in proportion to a program’s potential return on investment.

Depending on the organization, different reward programs will yield different returns, which should influence their design and efforts. For example, one of our clients recently reevaluated the various components of their executive compensation program. With the help of our objective view, they realized that their merit pay program was really a cost of staying competitive but not a motivating factor. In contrast, their annual incentive program touched many of their people and focused them more closely on results, yielding a much higher return. This influenced the client to devote more time and effort on their incentive of their program. Figure 3 illustrates their rationale.

**Figure 3: Reward Vehicle**

<table>
<thead>
<tr>
<th>Reward Vehicle</th>
<th>Investment</th>
<th>ROI</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term Incentives (Stock Options)</td>
<td>Low</td>
<td>Medium</td>
<td>Rewards senior executives for building sustainable shareholder wealth, and a retention vehicle for key employees.</td>
</tr>
<tr>
<td>Annual Incentives</td>
<td>High</td>
<td>High</td>
<td>Touches many people in the organization, but also focuses them on results.</td>
</tr>
<tr>
<td>Annual Salary Increase (Merit Pay)</td>
<td>High</td>
<td>Low</td>
<td>Cost of staying competitive as an employer, but not a real motivating factor.</td>
</tr>
</tbody>
</table>

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Six Principles To Establish a System of Truly Differentiated Rewards

1. Remember the "Management" in Performance Management

Organizations spend significant time and energy trying to figure out the best rating systems and evaluating their employees. However, in the absence of a “silver bullet,” it is important to revisit the essential components of effective performance management:

- Clarity of Goals
- Frequency of Dialogue
- Differentiated Performance and Rewards

Effective management is the thread that ties these factors together. It is our experience that managers will comply with any ratings scale given to them. But the most capable managers can best differentiate performance and then effect the results in their people that the performance management process is intended to influence. The good news is that the skills that managers need to enable an effective performance management process can be developed through formal training and ongoing coaching.

After Raytheon brought a focus on dialogue and development to a GE-style performance management system, the result was greater employee buy-in and satisfaction. In addition, they built a solid foundation for improvement by enabling employees to better understand their strengths and weaknesses.

2. Money Talks, So Secure Funding

For the most part, good managers can clarify goals, create a culture of dialogue, and differentiate performers. However, if funding is not in place, they will not be able to differentiate rewards significantly enough to recognize outstanding performers. Organizations that establish funds to differentiate rewards will get significant return on their investment. If an organization is truly committed to paying for performance, then a single merit budget that adjusts for market pricing and internal equity will not work.
Organizations might also consider “unbundling” the market competitiveness component from the performance component of their merit increases, in a manner similar to that of Fidelity. This prevents average performers from interpreting the wrong message if they received a significant increase for internal equity purposes.

Given the conventional constraints of merit pay, organizations may want to consider allocating a portion of their compensation investment to reward those who have truly achieved outstanding performance. This is especially true at the executive levels.

### 3. Differentiate Rewards, Not Just Performance Ratings

Organizations need to ensure that performance ratings translate into differentiated rewards.

Many organizations spend an agonizing amount of effort to ensure that managers “comply” with some sort of a distribution curve of performance ratings. But what value is this if the highest performer still receives only marginally more rewards—whether it is merit pay, incentive pay, or options—than the average performer? The ratings are merely a means to an end, and the end is higher rewards for the highest performance, not just a perfect distribution curve.

### 4. Set Clear Performance-Reward Linkages

Organizations must ensure that their employees understand what they are being asked to do to earn their rewards, and that their individual goals are based on a realistic view of the future and connected to what the organization needs to do to succeed in the future. Furthermore, the magnitude of the reward must be consistent with the value of the goal to the organization.

Fidelity’s annual bonus program is based on achieving a “doable” number of predetermined goals that support the company’s key strategic objectives and are again set to reward truly outstanding performance. A portion of the annual bonus over a certain threshold is deferred as a retention vehicle. They also have a mid-term incentive program, delivered in the form of phantom shares, to drive employee behaviors towards achieving longer-term results, support retention of middle- to senior-level employees, and provide competitive total cash.
Employees at all levels are more motivated to give extra discretionary effort in their jobs when they feel connected to the bigger picture and understand how their actions contribute. This is both a variable pay issue and a communication issue. Goals and measures have little value if employees are unaware of how they are progressing toward the goal until they have either met or missed it. This means that ongoing dialogue is essential to achieve a lasting impact. Performance management becomes the way strategic change is achieved, and business drivers (e.g., customer service or quality improvement) go from being mere words to being operationalized as a part of each person’s job.

We also recommend cascading objectives down to link individual with organizational performance measures. When narrow definitions are used exclusively as the foundation of performance goals, everyone works to meet a functional target. However, these measures can optimize particular departments at the expense of overall business goals. Sales goals established by the sales organization can run afoul if production doesn’t keep up with sales. If a distribution center is measured on product turns, it takes only the number of products it has ordered from the factory, regardless of the quantity the factory produced. Unfilled orders may result, even though the organization has produced the product.

5. **Focus Program Design: Don’t Pay for the Same Outcome Twice**

This has been said before, but it is worth repeating: Organizations should focus their program design so they don’t pay for the same outcome twice, or even three times over.

One option is to follow Fidelity’s example by having merit increases be tied to achieving core elements in a job and incentive awards tied to achieving the most critical results that enable the organization to achieve strategic and operational objectives.

Merit increases should be given to stay competitive in the labor market, which, in turn, should pay people for performing competently in their job-period. Incentive pay should not be confused with profit sharing based on the organization’s overall performance. Incentive pay must be tied to an individual’s unique goals or it will not differentiate and reward accordingly.
Organizations should determine which factors they are measuring to determine merit increases and which factors they are measuring to determine incentive pay. And, these should be distinct.

6. Communicate, Communicate, Communicate

Anything concerning compensation is a sensitive internal issue. For good or for bad, it is the most prominent concrete measure of an employee’s worth to the organization. Compensation decisions and compensation changes are always highly charged. While managers overwhelmingly acknowledge this, only 23% of organizations involve employees in the actual plan design.

Some managers expect merit increases, or the lack of increases, to take the place of an active performance management process. However, merit pay increases are not significant enough to manage a poor performer out of the organization, manage the potential of a high performer, or motivate employees to acquire the skills and competencies to perform effectively in their roles.

Effective communications between the organization and manager to the employee are essential to effect change. The goal is not necessarily a large volume; communications strictly by the pound generally result in overload and diminished returns. Make no mistake: no amount of communication—no matter how well focused or elegant—can rescue an ill-conceived compensation program. But many sound programs flounder when employees do not get the right information about it in the right way and at the right time.

Gillette is very explicit in their communications to employees when it comes to their performance. This includes being very clear if they have received an above-target bonus because of strong corporate and unit performance but substandard individual performance.

Raytheon drove their performance management initiative from their executive team, with HR helping business leaders to model correct behavior and deliver consistent assessments, ratings, development actions, and feedback for employees.

Organizations need to have a game plan for communications—and content for communicating program design attributes and key principles. In addition, they should provide managers with tools and talking points about topics such as what “superior” performance looks like, how performance management and reward systems link to the business strategy, and how to deal with tough questions.
Conclusion

Most organizations and people we survey have serious questions about the effectiveness of pay-for-performance programs. In the wake of tough questions and rumblings of managers and employees, they try tactical, simplistic changes, such as revising the number of ratings categories, issuing edicts to differentiate, and using forced distributions, without achieving any meaningful change or improvement in performance. Often these initiatives are driven by the compensation managers, who lack the clout to bring together all of the conditions needed for a successful program.

The purpose of this paper has been to explain why these changes have been difficult to achieve and to table some suggestions to overcome these obstacles. Getting managers to follow rules is generally quite easy, but getting them to manage better requires a much more significant commitment from the organization—one that goes beyond the compensation manager’s scope.

Treating pay for performance purely as a compensation issue will lead to further frustration. Conversely, setting clear goals, establishing a culture of dialogue and differentiated rewards, and having top-down support align employee behavior with business objectives and create the foundation for an engaged and productive workforce.
About Hay Group

Hay Group is a global consulting firm that works with leaders to transform strategy into reality. We develop talent, organize people to be more effective, and motivate them to perform at their best. With 88 offices in 47 countries, we work with over 7,000 clients across the world. Our clients are from private, public, and not-for-profit sectors, across every major industry and represent diverse business challenges.

For over 60 years, we have been renowned for the quality of our research and the intellectual rigor of our work. We transform research into actionable insights. We give our clients breakthrough perspectives on their organization and we do it in the most efficient way to achieve the desired results.

Our focus is on making change happen and helping people and organizations realize their potential.
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