Pay for Performance and Motivating Professional Development

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What is PFP?

Pay for performance, also referred to as merit pay, is a compensation system that rewards employees relative to their job performance. When meeting or exceeding goals, individuals receive greater compensation compared to if they fall short of targets.

Advocates of PFP believe that compensation is a motivator and that greater quality and quantity of work can be incentivized by rewarding employees accordingly. Employees whose work does not meet goals may be incentivized to seek relevant training to strengthen skills or pursue a different role that is a better fit. Proponents believe PFP can lead to fairer compensation, strengthen the organization and boost morale.

Opponents criticize PFP of evaluating complex jobs with simplistic measures, possibly undermining quality, productivity and engagement. An often-cited concern is the potentially subjective judgement of employee performance and the challenge of applying the PFP plan to roles more complex or critical than those that are mostly mechanical.

Do Compensation Motivates Behavior?

Recruitment: there is a sorting effect in that people choose organizations based upon personal preferences regarding compensation. Higher performers more likely to join organizations that embrace pay based upon individual performance.

Retention: there is a sorting effect where people dissatisfied with their pay leave organizations. Turnover for poor performers is higher with PFP systems. High performing employees are less likely to leave when performance bonuses are used.

Development: there is anecdotal evidence suggesting that employees are more likely to develop job skills because of pay.

Performance: there is an incentive effect that can motivate employees to perform better... IF the PFP plan is designed and implemented properly.

The Carrot Garden

It must be crystal clear what gets assessed to arrive at PFP and this merit system is most successful when integrated with other HR functions to motivate behavior. This broader array of rewards comprises the Total Returns (or Rewards) Model.

Pay for performance can be individual focused to incentivize higher productivity gains or group focused to improve team coordination. Most organizations that use PFP do a combination.

Effective PFP depends upon efficiency, equity and compliance. PFP must be customized to individual jobs. No one size fits all.

Efficiency relies upon a strategy for the PFP plan to support organizational objectives, a structure decentralized enough to allow different operating units flexibility in developing variations of the plan, and standards to make good decisions regarding performance objectives and measures, eligibility and funding.

Equity refers to the distributive justice and procedural justice of the plan. The outcomes and the process must be perceived as fair.

Compliance is about minimizing legal costs and protecting the reputation of the organization.

Changing Philosophies

Historically, pay seen as entitlement, but in recent years there has been a major shift in compensation with larger share of pay tied to individual or organizational performance. This change in perspective is driven by increasing global competition with a lower cost to lower wages and raise productivity. Fast-paced business environments necessitate nimble workers. A way to promote nimbleness is with PFP.

Merit pay links increases in base pay to how highly employees are paid for performance evaluation. Keys to success are accurate performance ratings, enough budget and differentials across levels large enough to motivate employees.

Merit bonus is a lump-sum not added to base pay. It has less sorting effect and controlling labor costs but is less popular with employees because it must be earned every year.

Group PFP plans can be by work team, department, division or entire organization. Standards must be developed against which group performance is measured. Performance appraisals don’t work well for groups as those are more personal in nature.

In business school we are taught that labor is an expense to be managed, but in reality, people aren’t an expense, they are an investment, an appreciating asset – the more we invest in them, the more we see productivity, customer service, innovation and growth.”

– Josh Bersin, Industry Analyst

References


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