

Why Pay for Performance is Inefficient and Directions for the Future

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RESUME

Today as in the 1980s, firms facing the challengers of national and international competition need to find new compensation systems oriented toward efficiency and better productivity. Notions of fairness, equity and other social dimensions lose their importance, as emphasis is put on economic dimensions like productivity, reducing costs, and responding to the competition facing firms and nations.

One approach which is frequently found in management literature, is based on the merit compensation system. Many organizations claim that they have used and continue to use a merit compensation system in order to improve their competitiveness, but it is not certain that this system responds to their needs, that this system is really new, or (even if this system is new), that they really have introduced a system that is better than the old system of traditional rewards. A merit compensation system, even if it is operating at its optimum, may not be adequate to respond to competitive pressures from poor countries (with low wage) and rich countries (with advanced technology).

Based on these observations, this article attempts to explain why merit compensation systems are inefficient by determining the limits from an economic and management viewpoint. The article gives also new directions, not necessarily based on a merit pay system, that firms need to take for the future in order to assure their success.

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I THE ORIGIN OF PAY FOR PERFORMANCE

It is easy to believe that all productivity problems met by firms can be attributed to the employees' poor performance, and that the solution can be found through the organization's compensation system. Thus the solution can be found through the organization's compensation system based on pay for performance. The idea is to motivate employees to work faster and/or better by knowing that in exchange they will receive more money.

1 Where Real International Competition Is Located

a - Competition in the 1980s

In examining international competition, it is very important to determine what kind of competition firms face in order to determine if a pay for performance will provide the edge or if some other answer is needed.

First, and this constituted the big problem during the 1980s, competition is related to a high gap in productivity and quality. This favored Japan where technological advances were recognized (Krafcick and

MacDuffie 1986, Porter 1990, Parkinson and Evan 1992), particularly in major sectors such automobiles, tools, and consumer electronics. In the automobile sector, as noted by Krafcick et al. (1986) and Womack et al. (1990), success was not only determined by the workforce (even they had to change their behavior and attitudes), but also by the creation and implementation of new technology provided by engineers, investment in R&D, and innovation coordinated with the workforce. Furthermore, the lack of technology that created an advantage for Japanese firms in certain sectors could not be overcome by the workforce (the difference in productivity is from 1 to 6 times in certain areas of productions: see Krafcick et al. 1986, Womack et al. 1990), but rather by developing the same technology, and only after this, is it possible for the workforce to make a difference, by creating a management oriented toward a pay for performance (the idea is that pay for performance motivates employees to work harder, because their output is rewarded).

This assumption is drawn from the expectancy theory which describes the conditions that must be met in order to use pay as a motivator: -the employee must believe that extra effort will improve performance, -the employee must perceive that better performance will be recognized and rewarded, -the reward system has to reasonably respond to the employee's expectation). As long as the competitive advantage created by technology is not overcome, all the potential energy of the workforce is insufficient, and a pay for performance can not make the difference, because it can be efficient only for firms struggling with the same advanced technology and innovation. Second, another type of competition faces firms. This type of competition develops when firms have the same level of technology, and the difference can be made by the unskilled labor cost (Cappelli, 1989, Porter 1990). More precisely, a comparison of the unskilled labor costs between France and Singapore shows the difference to be 1 to 4 (Statistical Abstract of the United States, 1991). In fact, the differential could not be overcome unless the pay for performance could increase the productivity by 400% for the French workers, an impossible goal, even with the good will of the workers. This gap in terms of wages can be diminished by developing new technologies that require less unskilled labor (Hood et al. 1989, Porter 1990). While waiting to develop new technology requiring fewer unskilled workers, firms from industrialized countries, including Japan, transfer the activities using unskilled labor to poor countries like Malaysia and Thailand (Porter 1990).

b - The competition for the future

Comparing the jobs that are currently available to the jobs that we will have in the 2000s, "workforce 2000" shows that 50% of new jobs will require an education equal or superior to a high school level. According to these observations, future competition will be determined by the degree of competency of the workforce in each nation. Moreover, Schuster (1992) argues that the lack of productivity is related in part to a lack of basic educational skills in the workforce which is therefore inadequate for firms' needs. Thus, firms need to train people in order to match the available work force with the skills necessary for the new technology that is essential for increasing productivity in the future in terms of quantity and quality. On the other hand, tomorrow's organization will exist in a highly competitive environment requiring change and adaptability, with employees being retrained frequently (Schuler 1992). Therefore, the new challenge for firms is to think about productivity brought about by new technology, but also to think about productivity brought about by a balance between the acquisition of skills and the utilization of new technologies. In fact, if pay for performance can improve productivity, the major question is whether this system can change the attitudes of people and make them more adaptable and more competent, assuming attitude is a part of Japan's success (White 1987). Thus, it would be interesting to understand the education level necessary to face new competition based on new jobs, new technology, and a new environment in order to adapt employee skills to meet the challenge.

2 Limits of pay for performance in an Economic Context

Paying people to be more productive is really efficient when firms located in the same sector compete with the same resources. These conditions can be met for firms located in the same countries, protected by the same rules (tax, union, law, and so on), or when the advantages and disadvantages between countries are not too disparate, permitting the pay for performance to nullify the advantages possessed by one firm. In this situation, a pay for performance based on better performance could be used in order to increase motivation (assuming that this motivation has some pertinent results on performance). If the pay for performance is the final determinant of the competitive advantage, we need to construct the first determinant based on new technology assuring a higher productivity, higher quality, and a higher standard of living. Indeed, if current research concentrates on pay for performance, what about the productivity that can be improved by the intellectual process (for instance, innovations introduced by quality circles), and the new technology that firms can create? Can pay for performance be a good predictor of creation of new technology? In that case, the struggle will be between productivity provided by physical effort and productivity provided by new technology. But we already know the winner, because too many wrong choices have been made in the past. Can merit pay systems substitute for the lack of investment and the lack of innovation.

II WHAT ABOUT THE REALITY INSIDE ORGANIZATIONS ?

The idea that pay for performance must be reintroduced in Western European and U.S. firms in order to compete with Japanese firms (among other things), was formulated during the 1980s. The economic defeat in many sectors (automobiles, tools, and consumer electronics, for example) prompted the Reagan administration to introduce a slogan: "pay for performance in order to improve productivity," (Lawler 1986), which was followed by many countries including France and Great Britain. This flight toward pay for performance led many to ignore the reality which is different from the discourse.

1 Pay for performance in its Reality

The notion of performance has become more ambiguous than it was in the past. In the 1900s, 80% of firms were located in the industrial sector, whereas today only 15% are. They have been replaced by firms located in the service sector (Kutscher and Personick 1986, Wallace and Fay 1988), leading that productivity is harder to measure. Pay for performance established during the 1900s, which is identified with a piece-rate pay system, based on a simple, repeatable task which directly linked performance and reward, is different from today's pay for performance, which in service firms is often associated with complex and uncertain tasks oriented toward a global economy (Hood et al. 1989, Porter 1990).

Within this global economy, the specific performance of each aggregate task is often subjective and difficult to determine, leading to invalid measures that can be contested by individuals (Beer and Spector 1985). In addition to this situation determined by the environment, other researchers have concentrated on the consequences determined by individuals. Meyer (1975) and Schusler (1992) show that the gap between the best performance and a bad performance is too small for the extra effort to be recognized and rewarded. Indeed, Hills et al. (1987) found a better correlation between the position occupied by an individual and the compensation received, than between performance and compensation. According to Lawler (1990), the lack of a gap can be attributed to supervisors not wanting to insult their subordinates, and therefore preferring to give the same amount to each employee, or to supervisors not receiving any training on assessing their subordinates, and, rather than risk making a mistake, giving almost the same increase to each employee.

2 Reaction to the Pay for Performance

By introducing pay for performance, firms have offered the opportunity to their employees to critique the pay system by showing that their performance is not related with their output. For example, the best employees observe the gap between the best performers and the bad performers and are less satisfied, and tend to quit the company for another company where they expect that their performance will be recognized (Beer et al. 1985, Lawler 1990), or reduce their performance in order to readjust their pay to their effort (for more details, see equity theory: Adams 1963).

Also, according to Slater (1980) and Kohn (1988), using incentives to motivate people leads to loss of quality because people will only pursue money. Indeed, in an environment requiring more quality and more attention, it is not certain that pay for performance can accomplish its role of motivation, or if it can, it will be a type of motivation related to quantity, but with a loss in quality, and the informal network not measured by any kind of reward will be lost.

III WHICH DIRECTIONS FOR THE FUTURE ?

By linking pay to performance, we have admitted that people are the key to success and that just by increasing the level of wages, motivation will improve, and by some miracle firms will be more productive and will reconquer the markets they have lost. But the reality is different because investment, management, and good decisions all contribute to success. Forgetting one of these results in failure.

1 The Investment in New Technologies

If compensation programs have played a large role in human resources research, we have to understand that the first flaw was to indoctrinate the organization world with the idea that the gain of competitive advantage can be won by firms by playing only this card. According to Womack et al. (1990) and Parkinson et al. (1992), the equipment and tools used in Japanese firms are newer than those used in European and U.S. firms. Such

evidence leads us to conclude that the Japanese success has in part been the result of the use of new technology. Of course, workers and innovations are important, but at the same time firms must invest in new technology. Even very motivated employees can not substitute for the lack of new technology.

2 Bring Competence with New Technologies

The time has come to stop creating new techniques out of ignorance that we know in all probability will be unsuccessful. It is better to spend time to understand the tools that we use today, and for some firms to return to past practices if analysis shows that previous system worked better. Japanese firms don't use merit pay systems, and their productivity is much better than that of U.S. firms and Western European firms. Unfortunately, by relying on one aspect, we forgot the real need to change which is located in the shift of jobs and work conditions (Wallace et al. 1988), provided by new technologies. The capitalist tradition pays people to buy their dissatisfaction, on the assumption that we don't need their competence but rather their silence (Lawler 1990). Today this assumption is obsolete, and the new economic reality oriented toward adaptability and higher skills needs the commitment and competence of each person (Lawler 1990, Schuster 1992). The question is: is pay for performance efficient to change behavior and produce attitudes too long forgotten by Occidental society but recognized by other societies which perform better than us in terms of productivity? According to Cappelli (1991), firms and nations have to work together in order to trace the needs of firms and the ways to face the inadequacies in the educational system. If firms try to train people for specific skills, the other problem is can firms provide the basic skills through education?

At this step of advanced technology, in order to be efficient in training programs it is necessary to determine the new objectives for nations, oriented toward basic skills, whereas firms will be oriented towards specific training. In any case, pay for performance, having demonstrated its limits must change its ideology. Because we know that productivity can be improved by improving skills, it will be more efficient to pay people not directly for their performance as determined by results, but rather for the skills they have acquired, because in a world that is more and more complex, the workforce will be certainly able to handle the new jobs only if competence is acquired (Ledford 1990). Although compensation systems have to attract, retain, and motivate people, firms have to overcome this approach and enter a new dimension which provides for adequate competence from their employees, by assessing the skills held by their human capital and the skills necessary for the firms of the future. Pay for performance could be used, not in a passive approach (reward people for their performance), but rather in a dynamic approach, permitting firms to narrow the gap between the skills needed and the skills held by their employees. Without this last dimension, responding to a new economy, the failure of firms is assured.

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