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End Entitlement: Pay for Performance

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Many organizations that took drastic pay actions to deal with the economic slump now wonder when the good old days will return. We suggest the answer should be, "Never." While that may sound harsh, our observation is that during the past 15 years "pay for performance" in many organizations deteriorated into a bland set of rewards based on a vigorous entitlement mindset.

The voices of entitlement express the following familiar sentiments:

- "All my people are high performers and deserve the top merit increase."
- "They need to figure out how to give me a decent bonus."
- "Our stock options are under water; the company should fix that."

For organizations that want to end compensation entitlement and move to true pay for performance, a business downturn is the best time to act — not just for the duration of the downturn, but also for the long term.

There is nothing wrong with strategies that include generous rewards or even an egalitarian approach to pay. A problem arises when an organization espouses pay for performance but accepts entitlement and then gets neither egalitarian teamwork nor motivation for high performance. To have pay for performance, pay must be differentiated to reflect the extent to which the individual and team contribute to the evidenced, measurable success of the employer.

Stranglehold on Pay

For many employers, their performance-oriented intentions have been squelched by the prevailing entitlement mindset. Following are several reasons:

- **A Focus on retention.** In the past 15 years, there were several periods of talent shortages in most industries. In an attempt to improve retention, many organizations adopted a compensation approach characterized by modest differentiation in base pay increases and bonuses and the broad use of long-term incentives. While such an approach helps retain average and low performers, it does little to retain high performers or improve company performance.
- **Pay practices.** Some policies and practices support entitlement. For example, it has become common for employers to announce their entire pay increase budget, (e.g., 3.5 percent for base pay increases). This makes every employee think he/she is entitled to at least the budgeted amount. In reality, most employees in this scenario should expect an increase of approximately 2.5 percent if the organization differentiates for high performers.
- **Familiarity.** An entire generation of managers and employees has never experienced any other type of environment but entitlement where base pay and incentives vary little from year to year and person to person. Even some of those who have lived through prior downturns have become soft on performance in recent years.
- **Fairness.** There is a misperception that fairness in pay requires treating everyone the same or the use of nonperformance-related factors, such as time in grade for promotions or pay increases, and organization level for long-term incentives. While easy to justify, these non-performance-related compensation determinants create entitlement.

Entitlement May Be Weak, But It's Not Over

Although many organizations broke the mold of full-merit increases and bonuses in 2009, they continue to harbor the wish that "this too will pass" and the old approach to pay will soon return. That could happen, because pay entitlement is hard to eliminate.

Entitlement is generally inconsistent with the need for higher organizational performance. Most organizations would be well served to stop the wishful thinking, declare entitlement dead and adopt a fundamentally different approach based on pay for performance.

What Pay for Performance Should Look Like

While there is no one correct approach to pay for performance, most employers should consider the following steps:

- **Use measurable performance to determine incentive payouts.** Companies should reward senior leadership and others, according to individual, work-team and business-unit performance rather than distant corporate performance. Bonus pools may be funded by overall company or unit performance, but the payout should reflect the impact that an individual or team had on performance. This requires more care in goal-setting below the corporate level than is the practice at many companies.
- **Replace the merit matrix as the means for determining base pay increases.** A merit matrix specifying percentage increases for performance ratings tends to cause gaming by managers. Some managers will inflate ratings to try to get more pay for all their people. More visibility of pay actions through calibration of pay recommendations across organizational units is a good way to reinforce high standards and reduce gaming that supports entitlement.

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- **Use salary ranges as guides, not givens.** Organizations should end employees' sense that they are underpaid if they are not near the top of the range. This may seem like a nuance, but it must be explained to employees that their pay opportunity is based on market and performance, not the range, particularly if ranges are adjusted for market.
- **Design long-term incentive plans so employees trade economic risk for rewards.** Organizations should de-emphasize base pay for executives (e.g., no restoration of base salary to pre-2009 levels). In exchange, executives (and a limited number of other key contributors) should participate in a long-term cash and equity program with a significantly higher upside opportunity if tough performance goals are achieved and dramatically reduced opportunities if they are not.
- **Don't spend the whole budget.** Just because pay increases, incentives and equity pools are budgeted, does not mean the organization actually has the money or should spend the whole budget. The assumption should be to spend only the budget justified by performance.
- **Pay attention to the top talent.** One of the fears about attacking entitlement is that it will increase turnover. Entitlement frustrates or even repels top talent. Some turnover is healthy. Meritocracy in pay helps ensure that the right people stay and leave.

Ending Entitlement Won't Be Easy

Rooting out entitlement to make way for a performance culture is an opportunity to be seized now. But it won't be easy. It will not happen by waiting to use old, familiar pay formulas. It requires a unified, sustained effort by business leaders and their HR partners to employ the new formulas and protocols for a performance-focused culture. WS

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