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AUTHOR	Twomey, Daniel F.
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ABSTRACT

The purpose of merit pay is to reward employees for their accomplishments and motivate them to continue improving. Critics of merit pay say the increased extrinsic motivation that it prompts is more than offset by the decrease in intrinsic motivation. Supporters of performance-based pay claim several benefits of the practice. This study addressed adding value to and improving the process of appraising and rewarding employees. Two major problems concern what is measured to determine merit and how it is measured. Some critics claim merit cannot be measured reliably. Problems with what is measured to determine merit include influence from outside forces, the accuracy of performance goals, and an emphasis on performance rather than ability and effort. Performance-appraisal and merit-pay practices must be redesigned. There are three major redesign elements that organizations must address. First, the inherent limitations of accuracy in all appraisal systems must be recognized and redesigned so they do not impose finite distinctions. Second, a broader range of employee contributions should be incorporated into the appraisal. Third, appraisal and merit pay should be viewed as a means of supporting the organization's overall strategy and a means for encouraging continuous improvement. (JPT)

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VALUE-ADDED MERIT PAY

Daniel F. Twomey

Center for Human Resource Management Studies

Fairleigh Dickinson University

Presentation for Symposium

PERFORMANCE APPRAISAL:

MORE MEANINGFUL MEASUREMENTS FOR MERIT PAY

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VALUE-ADDED MERIT PAY

The purpose of merit pay is to award employees according to their contrubutions to the organization and to provide motivation for continuing contributions (Gomez-Mejia and Balkin, 1992). If that purpose were fully operationalized then much of the controversy around merit pay would be moot. Some of the criticism of merit pay is that its net effect is negative. It doesn't add value to the organization, e.g. the increased extrinsic motivation that it prompts is more than offset by the decrease in intrinsic motivation. Deming takes a strong stand against merit pay and articulates many of the potential negative consequences. On the other side of the controversy are advocates for performance-based pay who claim several benefits for their position. At the heart of the controversy is the net value added by merit pay. In this article, instead of joining sides in the controversy, ways of increasing the value added by merit pay will be addressed. Many firms are presently struggling with this issue and and are reassessing the process for determining merit pay, in particular, performance appraisal. The article addresses the underlying issue of adding value and reports on the efforts of some organizations to improve the process of appraising and rewarding employees.

Merit has many meanings. Some organizations use the word "merit" for pay increases that do not become part of the base and others use it to mean all contingency-based pay. It is this latter definition that is used here--any pay that is based on performance or other contributions to the organization.

UNDERLYING ISSUES

At least two aspects of merit seem to be problematic: (1) What is measured? and (2) How well it is measured? The choices in these two areas have major consequences. Much of the controversy about the consequences seems to focus on the second issue and those individuals who are most critical of merit pay see little hope for reliable measurements and therefore oppose the use of merit. Deming says firms should abandon the use of performance appraisal systems, including merit pay (Scholtes, 1987). He sees the traditional performance appraisal system as creating fear, win/lose competition, short-term focus, more concern with the past than with the future, hurting teamwork, and increasing politics. In essence, people feel beat up by the process.

What is Measured

A problem with traditional appraisal systems that impacts merit pay is the narrow focus on individual behaviors. Generally an employee's performance depends on factors beyond the job. These factors include the supervisor, peers, and in the case of managers, subordinates, as well as the support systems and processes. They may be more of a determinant of the employee's performance than is the employee's ability and effort. Another problem, in situations where goals/measurements are set, is the accuracy of the prediction. If the predictions are off and the employee is still judged against those goals/measurements, the result is an unfair rating. In many organizations goal

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achievement is rated in much the same way as overall performance with one or two rating categories above "satisfactory", eg. "somewhat exceeds expectations", and "substantally exceeds expectations". In the goal setting process typically the employee is instructed to set "stretch" goals. By definition the "stretch" goal is more than satisfactory, but just achieving that goal would create a "meets goals" or "satisfactory" rating. To make the system fair the employee must set lower "not stretch" goals. Finally, an employee contributes much more to the organization than short-term results. Besides long-term results, the behaviors, skills, and knowledge of employees will determine the success of the organization. Most appraisal systems do little to measure either the current levels of these competencies or how much they are improved.

How Well Measured

How well contributions are measured is partly determined by the decision process. In many merit systems there are two sets of judgements. The appraiser, i.e. the immediate manager, makes the initial rating. This rating is subject to rater error and rater bias. The sources of both are well documented. Even with training the degree of accuracy is limited. But it is not just the appraiser who determines the merit pay for individual employees. A typical pattern is to have a group of managers at a higher level rank the employees under them who have similar jobs. In a large telecommunications company supervisors set the goals with employees and at the end of the performance period rate their subordinates' performance. Then a group of the management peers compare the performance and ratings of their respective subordinates and, based on a pre-set number of available slots at each level, reassigns ratings/rankings. Since these managers have limited first-hand knowledge of the performance of other units' employees and even less knowledge of their goals, the process regresses into a political contest (Longenecker, Gioia, and Sims, 1987). Power and persuasion of the manager at times become more important than the achievements of the employee. The degree of distortion would tend to be greater as the number of levels between the appraiser and the managers who decide merit increases. The reason for this is that the decision maker has less and less first hand information, and the basis of the decision switches from comparing performance against performance expectations to comparing one's performance with another in a competitive environment--your people are either going to be winners or losers based on your presentation of them. When a supervisor rates an employee it is the individual job expectations that are the standard by which the performance is judged. In contrast in the high-level pay decision meeting the individual's job expectations are not known by most of the decision makers and knowledge of actual performance is second or third hand. So the process is comparative but it lacks a common standard; therefore, it is a bit of "apples and oranges".

Why Use Merit

A question that should be asked is, "With all of the measurement problems and potential dysfunctional consequences as articulated by Deming and others, why use merit pay?" Reasons include that top management may be committed to the ideal of performance based pay--it works for them. At the theoretical level the practice of merit pay is supported by expectancy theory (Vroom, 1964 and Lawler, 1971). Merit pay has many other potential benefits including motivating employees, strengthening a performance-oriented culture, attracting and retaining high performers, (Mohrman, West, and Lawler, 1989). In those situations in which merit pay is a required part of the system or where it is believed that the advantages of merit pay potentially outweigh the problems a principle driven design for merit pay should be created. The principles should go along way in assuring the the system is mostly positive.

SUBJECTIVE NATURE OF RATINGS

Management practices and academic research frequently reflect an assumption that finite measurement as possible. This attitude is reflected in systems that have rigid and highly differentiated ratings. An example is organizations that rank-order employees for merit pay. About one third of large firms use ranking by higher levels (Bretz, Milkovich, and Read, 1991). Much of the research on performance appraisal focuses on narrow aspects of the accuracy issue. Academic journals are replete with research studies on the micro aspects of performance appraisal, in particular, cognitive processes (Bretz, Milkovich, and Read, 1991). The papers presented at the 1989 national meeting of the Academy of Management in a session entitled Decision Making and the Performance Appraisal Process were: "Effects of Self-Esteem on Leniency Bias in Self Reports of Performance", "How

Subordinate Prosocial Behavior Influences Performance Ratings", "Attributional Processes in Performance Appraisal: The Moderating Impact of Interpersonal Closeness", and "Chronic Category Accessibility and Mood Influence and the Accuracy of Appraisal Ratings" (Hoy, 1989).

The problems of management research, recently articulated by Bedeian (1989), apply particularly to performance appraisal. Addressing the status of research the President of the Academy of Management discussed "mindless" research. Finite and specialized research, driven by research methodology without any grounding in reality is, in Bedeian's words, "theory thin" and "method driven". We continue to conduct micro research on performance appraisal where macro theories are weak and management practices are ineffective. Academicians are busily fine tuning the micro aspects of performance appraisal such as accuracy of judgements while ignoring the impact of organizational change on these management systems.

The recognition that rating accuracy is limited even in the best of circumstances may cause practitioners to design systems that are more realistic in that they don't pretend to create certainty and distinction beyond what is feasible. Even if one assumes that the rater is objective and has avoided the problems of central tendency, projection, rate inflation, halo effect, and stereotyping, there is still the system and process considerations that limit the employee's control of performance and thereby the rater's accuracy. New practices seem to reflect this reality. Several organizations have reduced their number of rating categories/levels to three to five typically, e.g. American Cyanamid, AT&T Computer Technology Lab, and GM transmission division. It would seem unlikely that anything with more than five or six rating category/levels has much reliability.

Changing the basis of ratings invalids the original system. When a group of middle managers rank employees, who have already been rated by their immediate supervisors, the basis changes from expected performance to other employees' performance. The ranking is a competitive-based process where the supervisory rating was a performance standard-based process. AT&T has eliminated the practice of having a group of managers rank order all employees as a means of establishing merit pay. Corning, Motorola, NYNEX, and Xerox have moved the decisions for deciding merit pay down to lower level managers, sometimes giving them an amount of money to distribute for merit.

MERIT PAY'S REFLECTION OF TOTAL CONTRIBUTION

In part the desire to tie pay directly to performance has prompted merit for short-term results. This is exemplified by the strict MBO approach to merit. Not only are the long-term contributions ignored, but so too are the behaviors and the indirect short term contributions. MBO systems in which goal achievement is the principal determinant of merit do little to encourage the development of competencies which are the basis of long-term success.

There appears to be a growing trend to integrate the longer range goals, skills, knowledge, and competencies into the merit pay decisions. Some firms have started putting more emphasis on the behaviors relative to the results. Others, e.g. AETNA, AMOCO, Digital Equipment Corp. and Public Service Electric and Gas (PSE&G) are experimenting with integrating competencies. PSE&G integrates competencies, specifies the generic and specific competencies needed for the long term success of the firm, and includes the level of competency achieved in the yearly overall assessment/rating, which is used as the basis for the merit.

Broadening the base of contributions considered in establishing ratings/ranking, and thereby merit, increases the validity of measurements. That is, the organization is rewarding what is most valuable to its long-term success. But the integration of long-term goals, competencies, etc. may reduce the reliability. Both need to be considered in the design of rating systems.

RATINGS AND MERIT PAY--A MEANS RATHER THAN AN END

The dilemma of evaluation and development elucidated by Meyer, Kay and French (1965) has not been resolved and seems to have been forgotten by researchers as they avidly pursue refinements of evaluation. The test of a merit system sometimes is its accuracy--validity and reliability. The pursuit of these criteria may cloud the fact that ratings and merit are not the end but a means to the end of increasing performance, and that achieving these criteria does not insure performance. There is considerable evidence that the focus on ratings/merit tends to drive out development. The focus on ratings also may limit continuous improvement, problem solving, and maybe most important, intrinsic motivation. The concern is that the organization may be trading (losing) substantially more intrinsic motivation in the performance appraisal process than it is gaining from the extrinsic motivation generated by merit pay.

Two new practices that interface with the performance appraisal/merit pay process are being talked about and experimented with by several organizations. The concern that prompts these practices has more to do with development and improving performance than with accuracy.

Some firms have adopted (NYNEX, Xerox, and Corning) or are experimenting with (Dupont, U.S. Airforce, and 3M) no-rating category appraisals. Generally, the summary or overall rating levels have been eliminated. The written description of the employee's performance becomes the bases for administrative decisions, including merit pay. By eliminating the rating levels, the focus can be shifted to understanding the performance and how it might be improved.

Development and performance and process improvement is facilitated by bringing more diverse information to the appraisal process, e.g., upward feedback or four-way--360 degree (immediate manager, peers, subordinates, and customers). As organizations consider and integrate the expanded feedback into the appraisal process, a central question is whether or not to incorporate it into the ratings/merit pay. The trend appears to be to limit 360 degree feedback to development. Both the quality of the information and the openness to receive the information, and thereby its effectiveness, would be reduced by making it evaluative. A similar analysis could be applied to the use of self-assessment.

CONCLUSION

Organizations seem to be at a crossroads with respect to performance appraisal and merit pay. These practices must be redesigned in ways that clearly add value or be eliminated.

This article reviews the controversy about appraisals and merit and explores some of the underlying issues. Three major issues that organizations need to address in redesign of current systems are presented. To establish a value-added performance appraisal/merit-pay system, an organization should (1) recognize the inherent limitations of accuracy in all appraisal systems and design system that do not impose finite distinctions; (2) incorporate a broader range of employee contributions into the appraisal, especially those that are critical to the long-term success of the organization; (3) view both appraisal and merit pay as a means of supporting the organization's strategy and a mechanism for encouraging continuous improvement. In particular merit pay should not drive out development and intrinsic motivation.

Making adjustments to current performance appraisal and merit pay system will not suffice. Old practices and underlying assumptions must be discarded and new designs based on different principles established. The practices reported on here are important pieces in creating systems that truly add value. Organizations are in a learning/experimenting process with regard to appraisal and merit pay, as they progress, a test of the new systems will be the degree to which they help the long-term viability of the organization.

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