Pay Day:
Pitfalls of Performance-Based Pay

In theory, pay-for-performance compensation plans make sense. In practice, they are much more complicated. This new research delves into the disparity between the predictions of economic theory and the reality of compensation choices to find out why performance-based pay may not always be the best plan for nonexecutive employees.

The dominant economic theory on strategic compensation predicts that many efficient businesses will compensate employees based on their individual performance. But in reality, pay-for-performance plans for nonexecutives do not occur nearly as frequently as that theory predicts.

Traditional theories have good reason to predict that performance-based pay may maximize efficiency. Theoretically, only highly skilled workers will be attracted by this type of compensation package since they know that, as over-performers, they would earn more. Consequently, this compensation strategy should serve as a sorting mechanism, weeding out low performers and even preventing them from applying for the job.

Traditional theory also suggests that financially motivated employees work harder than those receiving a fixed salary. So if performance-based pay ensures a workforce of highly skilled, hardworking employees, why don’t more managers adopt it? There are several reasons.

Pierce and his research colleagues focus on two important psychological factors that increase the real costs of pay-for-performance:

1. Tendency for people to compare their income to others’, especially their peers
2. Workers’ overconfidence in their ability to perform familiar or oft-repeated work

When an employee compares his or her income to that of his or her peers—easier than ever thanks to social networking—the result is profound on individuals and organizations. Especially when performance metrics are subjective or not easily observed, employees see differences in pay rates as inequities, not reflections of varying worker performance.

Employees’ feelings of injustice can lead to:
- Decreases in quantity and quality of work
- Higher levels of attrition
- Lower morale and commitment to the organization
- Potential sabotage or unethical behavior

These effects all represent added costs to an organization that suggest pay-for-performance may not be as effective as employees believe.

“People don’t really think of money and compensation as just money and compensation. They think of it as a statement on their own net worth and pride,” Pierce says.

On the second factor—overconfidence—people often overvalue their abilities, especially on frequent, easy, or familiar tasks. They then believe they would fare well under a pay-for-performance system.

In fact, the opposite frequently occurs, and employers are less able to sort out less skilled workers. As a result, employers use pay-for-performance even less.

What, then, is the optimal compensation scheme?

“There is no one solution, and a lot of it really depends on the type of employee you’re working with,” Pierce says.

Some workers, for example salespeople, actually benefit from overconfidence, suggesting that pay-for-performance might work well for them. But in other situations that is not the case.

Take the example of research and development workers tied to high-incentive pay structures. They might risk too much on new products or process development. Similarly, for companies that rely heavily on internal teamwork and cooperation, employee comparisons to one another are likely to hurt the organization in a pay-for-performance model.

The lesson is that human behavior dramatically impacts the effectiveness of compensation systems. By understanding the needs of the tasks to be performed and the needs of the people who will be performing them, managers can develop compensation packages that are far more effective for recruitment and for organizational efficiency.

Psychology and social networking play a bigger role than previously realized in adopting pay schemes, according to the new study.