The objective of this Lecture and Research Update is to examine the controversy surrounding pay-for-performance plans. One school of thought argues that extrinsic rewards decrease intrinsic motivation. Therefore, making rewards contingent on performance is ultimately detrimental to the organization. On the other hand, proponents of performance-based pay assert that it is a valuable management tool used to direct employee effort and motivate higher performance. The conceptual grounding of each perspective is described in more detail below.

Opponents of Performance-Based Pay

The primary criticism of pay-for-performance programs is based on Cognitive Evaluation Theory, which asserts that extrinsic rewards decrease intrinsic motivation (Deci & Ryan, 1985). Simply stated, individuals need autonomy and self-determination. To the extent that performance-contingent rewards are perceived as externally “controlling” one’s behavior, intrinsic motivation (the internal satisfaction one would normally feel in performing the same task) is predicted to decrease.

This theory was supported in early experiments with school children. One group of children was rewarded for how well they performed a given task (a game) and then was given free time in which they could continue to perform that task (but without the possibility of earning a reward). When the incentive was no longer available, children in this group spent less free time at the task than the group of children who had not received any type of performance-based reward.

Taking the argument against performance-based pay even further, Pfeffer (1998) contends that merit pay, a form of individual pay-for-performance, “has been shown to undermine teamwork, encourage employees to focus on the short-term, and lead people to link compensation to political skills and ingratiating personalities rather than to performance” (p. 115). In other words, individual performance-based pay can stimulate an unhealthy degree of competition and reduce cooperation among workers. Advocates of Total Quality Management, therefore, have discouraged the use of such plans (Deming, 1986).

Furthermore, Kohn (1993) argues that performance-based pay actually undermines the very processes leading to higher performance that it was intended to enhance. The notion that managers should motivate their workers by identifying what is important to them and offering it in exchange for some desired behavior (Milkovich & Newman, 2004, p. 261) amounts to a “bribe” that will ultimately backfire.

The shortcomings of extrinsic reward systems within organizations were recently summarized by Spitzer (1996):

Excessive dependence on monetary rewards

Lack of an “appreciation effect”

Entitlement effects

Undesirable behaviors being sometimes rewarded

Too long a delay between performance and rewards

Too many one-size-fits-all rewards

Short-term impact

The continued use of de-motivating practices that often accompany performance-based pay. (pp. 46-50)

According to this perspective, the key to performance lies not with some type of incentive pay scheme. Rather, the key is to recognize that workers care about more than simply the size of their paycheck. They care about work that is meaningful and enjoyable (this claim reiterates the aforementioned emphasis on stimulating intrinsic motivation). Therefore, other factors within the organization should be leveraged to maximize performance, such as job design and the organization’s culture (Pfeffer, 1998).

Proponents of Performance-Based Pay

Proponents of performance-based pay contend that base compensation does little more than motivate workers to show up for work and do enough to avoid getting fired. Performance-based pay supplements base pay, clarifies what employee behaviors the organization values, and directs employee efforts accordingly (Milkovich & Newman, 2004). Indeed, as mentioned in Lesson 1, pay-for-performance programs can have greater effects on employee effort and performance than any other single type of motivational program: “Money is the crucial incentive because, as a medium of exchange, it is the most instrumental. . . . No other incentive or motivational technique comes even close to money with respect to its instrumental value” (Locke, Feren, McCaleb, Shaw, & Denny, 1980, p. 379). Lock et al. found a 30% median performance improvement for pay-for-performance, relative to 16% for goal setting programs, 8.75-17% for job enrichment programs, and .5% for employee participation programs.

The effectiveness of pay-for-performance programs is predicted by a number of theories, including equity theory, expectancy theory, goal-setting theory, agency theory, and reinforcement theory. We will briefly review each of these in turn.

Equity Theory. Equity theory (Adams, 1965) contends that individuals are concerned with the fairness of rewards received for their contributions, in other words, that their pay is an issue of distributive justice. This theory also claims that individuals desire to be rewarded based on their individual merit. Equity theory states that individuals compute the ratio of their outcomes (in this case, their pay) to their inputs (in this case, their level of performance). By comparing their outcome/input ratios with other employees, these individuals form perceptions of how fairly they are paid. Equity theory predicts that individuals may take action to restore equity if they are either underpaid or overpaid compared to a referent other, although underpayment inequity usually prompts much more corrective effort than overpayment inequity. For example, if Mary performs at a higher level than Joe, Mary should receive comparably higher pay. Pay-for-performance programs should be effective to the extent that they reward individuals commensurate with their level of performance.

Expectancy Theory. This theory (Vroom, 1964) predicts that workers make choices about how much effort to exert at work based on three considerations:

Their expectancy that their efforts will lead to a certain level of performance

Their belief that their level of performance will lead to a certain outcome (instrumentality)

The attractiveness of the outcome (valence).

Therefore, workers need to understand clearly what the performance standards are and how they can achieve them (expectancy). They also need to perceive a connection between their level of performance and their level of pay (instrumentality). Finally, they need to value the additional amount of pay they receive based on their performance (valence). Pay-for-performance programs should be effective to the extent that they result in strong levels of expectancy, instrumentality, and valence.

Goal Setting Theory. Goal-setting theory proposes that performance goals are powerful motivators (Locke & Latham, 1990). Specifically, greater effort and higher performance are associated with difficult and challenging goals. This theory predicts that goals further clarify what performance standards are expected; incentives alone may not sufficiently convey what level of performance workers are supposed to attain (e.g., the statement “Workers will receive raises based on merit” is somewhat vague). In addition, linking monetary incentives to goals may be beneficial in getting employees to set or accept a particular goal and in keeping them committed to reaching the goal. Research on goal-setting indicates that the effects of implementing difficult, specific goals can lead to enduring increased performance, even up to several years later. Pay-for-performance programs should be effective when they make pay contingent upon reaching difficult and specific performance goals, and the amount of the incentive should match the difficulty of reaching the goal.

Agency Theory. Agency theory (Eisenhardt, 1989) contends that the interests of principals (managers) and their employees (agents) often diverge. Because employees are posited to find work aversive, they find ways to maximize their self-interest by shirking (withholding their maximum performance) whenever possible. Managers solve this problem by aligning the interests of the workers with organizational objectives. Tying pay to performance makes rewards contingent upon workers obtaining desirable outcomes, that is, desirable to management. Pay-for-performance programs should be effective when pay is tightly linked to key organizational objectives and when total pay is higher to offset the additional risk workers assume by foregoing static wages.

Reinforcement Theory. This theory is grounded in Thorndike’s (1913) law of effect, stating that when a behavior is rewarded, it is more likely to occur in the future. In terms of compensation, high performance followed by a monetary reward will be more likely in the future, while high performance not accompanied by a reward will be less likely in the future. It is essential that performance-based rewards do, in fact, motivate desired behaviors and avoid rewarding undesirable behaviors (Kerr, 1995). Pay-for-performance programs should be effective when rewards closely follow desired performance.

To summarize, these theories converge in their prediction that pay-for-performance programs motivate higher employee performance. These theories also provide a number of stipulations regarding the conditions under which these beneficial effects occur. The proponents of performance-based pay assert that this type of reward system can be very effective if it complies with the conditions specified in these theories. In addition, performance-based pay may not be sufficient in and of itself to motivate higher performance. Tailoring the program to the unique context of the organization may be a vital consideration (Heneman & Gresham, 1998). Human resource managers should not focus exclusively on pay and neglect other types of rewards that employees value (Milkovich & Newman, 2004, p. 274). Similarly, managers should ensure that their pay program is grounded in the organization’s culture and overall performance management system (Milkovich & Newman, 2004, Exhibit 10.10 on page 295).

Lecture and Research Update Bibliography

Adams, J. S. (1965). Inequity in Social Exchange. In L. Berkowitz (Ed.), Advances in Experimental Social Psychology (Vol. 2, pp. 267-300). Orlando, FL: Academic Press.

Deci, E. L., & Ryan, R. M. (1985). Intrinsic Motivation and Self-Determination in Human Behavior. New York: Plenum.

Deming, W. E. (1986). Out of the Crisis. Cambridge, MA: MIT Center for Advanced Engineering Study.

Eisenhardt, K. M. (1989, January). Agency Theory: An Assessment and Review. The Academy of Management Review, 14(1), 57-74.

Heneman, R. L., & Gresham, M. T. (1998). Performance-Based Pay Plans. In J. W. Smither (Ed.), Performance Appraisal: State-of-the-art Methods for Performance Management (pp. 496-536). San Francisco: Jossey Bass.

Kerr, S. (1995, February). On the Folly of Rewarding A, while Hoping for B. The Academy of Management Executive, 9(1), 7-14.

Kohn, A. (1993, September-October). Why Incentive Plans Cannot Work. Harvard Business Review, 74(5), 54-60. (Abstract only.)

Locke, E. A., Feren, D. B., McCaleb, V. M., Shaw, K. N., & Denny, A. T. (1980). The Relative Effectiveness of Four Methods of Motivating Employee Performance. In K. D. Duncan, M. M. Gruenberg, & D. Wallis (Eds.), Changes in Working Life (pp. 363-388). New York: Wiley.

Locke, E. A., & Latham, G. P. (1990). A Theory of Goal Setting and Task Performance. Upper Saddle River, NJ: Prentice Hall.

Milkovich, G. T., & Newman, J. M. (2004). Compensation (8th ed.). Boston: McGraw-Hill Irwin.

Pfeffer, J. (1998, May-June). Six Dangerous Myths about Pay. Harvard Business Review, 76(3), 108-119. (Abstract only.)

Spitzer, D. R. (1996, May). Power Rewards: Rewards that Really Motivate. Management Review, 85(5), 45-51.

Thorndike, E. L. (1913). Educational Psychology: The Psychology of Learning (Vol. 2). New York: Teachers College.

Vroom, V. (1964). Work and Motivation. New York: Wiley.