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Is There Merit in Merit Pay? A Survey of Reward Professionals

K. Dow Scott
Loyola University Chicago, dscott@luc.edu

Rena Somersan

Brian Repsold

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Dow Scott, Ph.D.
Loyola University Chicago

Rena Somersan
Verisight Inc.

Brian Repsold
Verisight Inc.

Merit pay is one of many rewards programs typically designed to link employee performance to pay. Merit pay programs are typically associated with the following characteristics:

- Individual rather than team incentive.
- The incentive award is permanently rolled into the individual's wage or salary.
- The incentive is based on past performance, often the previous year's.
- Performance is assessed by one's supervisor, who may consider goal/objective attainment, job behavior or individual performance against job standards.
- A merit pay guide chart (or merit matrix) is often used to link individual performance ratings and position range with size of the merit increase (Milkovich, Newman, and Gerhart 2014; Werner and Heneman 2007).

Merit pay programs are also associated with pay structure adjustments to keep pay levels in a desired competitive position among the organization's labor market competitors. Pay structure adjustments were once made by awarding employees a general increase, where everyone received either the same dollar amount or the same percentage of their pay or a combination of both. These increases were automatic and often associated with cost-of-living increases (i.e., inflation adjustment). In the 1960s and 1970s, general pay increases were replaced, in large part, by merit pay programs, where pay increases were differentiated by individual performance (WorldatWork 2012), such that high performers would move to the top of the pay range and poor performers would fall to the bottom of the range.

Merit pay was argued to be superior to general pay increases for a variety of reasons. It was thought to:

- Motivate employees to perform at higher levels by linking pay to performance.
- Motivate top performers to stay (i.e., retention) and poor performers to leave by positioning top performers toward the top of the pay range and poor performers toward the bottom.
- Communicate to employees that the organization has a performance-driven culture (i.e., meritocracy).
- Force managers to distinguish between high performers and low performers to allocate limited merit increase budgets.

These reasons were obviously compelling because general pay increases and cost-of-living increases were, for the most part, replaced by merit pay programs with 80% to 95% of organizations reporting having one (Milkovich, Newman, and Gerhart 2014; Scott, Sperling, McMullen, and Wallace 2003; Werner and Heneman 2007).

Unfortunately, more than 50 years of experience with merit pay plans has indicated they are often associated with problems and are sources of employee dissatisfaction (Eskew and Heneman 1996; Hills, Scott, Markham, and Vest 1887; McGinty and Hanke 1989; Pearce and Perry 1985; Werner and Heneman 2007). These problems include:

- Subjective performance ratings, resulting in favoritism in awarding increases.
- Employee dissatisfaction with size of pay raises.
- Supervisor reluctance to differentiate merit increases among employees.
- Inconsistent individual performance levels over time, resulting in employees not performing at levels consistent with their pay continuing to be paid at the top of the range.

Since the inception of merit pay programs in the United States, these problems have often been associated with fundamental changes in economic conditions and how work has been organized. Inflation has been low for two decades and, as a result, merit budgets have dropped from almost 10% to 15% in the 1980s to 2% to 3% today (Werner and Heneman 2007). Second, pay ranges have widened, making it more difficult for even top performers to reach the top. Third, increased use of bonuses and equity payments has become the preferred methods for rewarding performance. Finally, work today is more associated with teams than with individual performance.

Given that merit pay programs are ubiquitous in industry, but often associated with problems, this study surveys rewards professionals to determine how these programs are designed and the degree to which they are effective. Based upon these findings, recommendations are made for best practices.

DATA COLLECTION METHODS AND RESPONDENT CHARACTERISTICS

Verisight, an HR consulting, retirement and trust services business, solicited compensation and HR professionals to participate in the research initiative from May through July 2014. Members from U.S.-based compensation and HR associations and Verisight clients were invited to participate. The questionnaire required 10 to 15 minutes to complete. More than 200 HR and compensation professionals, all from the United States, completed the survey.

Participating organizations varied considerably in size. About 10% of respondents had fewer than 100 employees: 25%, 100 to 1,000; 26%, 1,000 to 5,000; 22%, 5,000 to 20,000; and 15%, more than 20,000. When size is defined by revenue, organizations were again divided into five categories: 17% with revenue less than $50 million; 23%, $50 million to $500 million; 16%, $500 million to $1 billion; 29%, $1 billion to $5 billion; and 16%, more than $5 billion.

Respondents were from a diverse range of industries. The largest representation came from manufacturing, 20%; health care and social assistance, 14%; professional, scientific and technical services, 14%; and finance and insurance, 10%. The remaining 46% was distributed throughout other industries. The organizations were also diverse in terms of ownership. Respondents represented publicly traded/listed companies, 33%; privately owned companies, 40%; not-for-profit, 23%; government, 2%; and other, 2%.

MERIT PAY PROGRAM GOALS AND EFFECTIVENESS

Almost two-thirds (63%) of the respondents reported that all their employees were eligible to receive merit pay increases. Twenty-five percent indicated that only salaried and exempt employees were eligible, and 12% indicated that only managerial and professional employees were eligible.

The numerous goals associated with merit pay programs are listed in Table 1. These goals are arranged in the table by reported importance from highest to lowest, with the majority of organizations utilizing multiple goals. Those goals considered most important to respondents included:

1 | Communicates to employees that the contributions they have made to the organization or department are appreciated (89%).

2 | Motivates employees to perform at higher levels (86%).

3 | Motivates top performers to stay (i.e., retention) by giving them larger relative pay increases or positioning them toward the top of pay ranges (84%).

4 | Communicates to employees that the organization is a meritocracy with a performance-driven culture (84%).

Table 1 | Merit Pay Program Goals and Effectiveness

	How Important are Merit Program Goals			How Effective are Merit Pay Programs at Meeting Goals		
	Not Important	**Marginally Important**	**Important**	**Not Effective**	**Marginally Effective**	**Effective**
Communicates to employees that the contributions they have made to the organization or department are appreciated	3%	8%	89%	8%	25%	67%
Motivates employees to perform at higher levels	2%	12%	86%	10%	32%	58%
Motivates top performers to stay (i.e., retention) by giving them larger relative pay increases or positioning them toward the top of pay ranges	3%	12%	84%	12%	27%	61%
Communicates to employees that the organization has a performance-driven culture (i.e., meritocracy)	8%	8%	84%	9%	29%	61%
Enhances employee perceptions of pay fairness by rewarding merit	4%	13%	83%	12%	29%	59%
Rewards the accomplishment of specific organizational behavioral objectives, such as teamwork or customer service	6%	12%	82%	10%	32%	57%
Forces managers to distinguish high performers from low performers for allocation of limited merit increase budgets	10%	10%	80%	11%	28%	60%
Attracts high performers (i.e., recruitment) to the organization	18%	18%	64%	25%	31%	44%
Motivates poor performers to leave (or improve) by giving them lower relative pay increases or positioning them toward the bottom of the pay range	15%	28%	57%	28%	41%	31%
Adjusts the pay structure to accommodate annual or bi-annual labor market increases, so high performers populate the top of the range and poor performers and new employees populate the bottom of the range	26%	27%	47%	21%	29%	50%
Discourages average or low performers from applying for jobs in your organization	60%	25%	15%	54%	32%	14%

5 | Enhances employee perceptions of pay fairness by rewarding merit (83%).

6 | Rewards the accomplishment of specific organizational behavioral objectives, such as teamwork or customer service (82%).

7 | Forces managers to distinguish high performers from low performers for allocation of limited merit increase budgets (80%).

These seven goals were considered important and very important by 80% or more of the survey respondents. Other merit pay program goals did not rate nearly as high with "Discourages average or low performers from applying for jobs in your organization" receiving the lowest important score (15%). Interestingly, the goal to "Attract high performers (i.e., recruitment) to the organization" was perceived as an important goal by only 64% of respondents.

The effectiveness of the merit pay program in achieving these goals is also shown in Table 1. The authors found the degree to which the merit pay goal is deemed important is positively related to the degree to which respondents think the program is effective in meeting that goal. However at best, 67% of respondents rate their merit pay program as effective in meeting their goals. This indicates that a sizable number of merit pay programs are not performing as effectively as HR and compensation professionals might wish.

Historically, merit pay programs have been implemented in place of general pay increases, so that high performers moved to the top of pay ranges and poor performers and new employees occupied positions toward the bottom of pay ranges. It was interesting to learn that only 47% of compensation and HR professionals indicated this was an important goal, and only 50% indicated that merit pay programs were effective in adjusting pay levels to reward high performers.

EFFECTIVENESS OF PERFORMANCE INCREASE CRITERIA USED TO AWARD MERIT INCREASES

The size of merit increases awarded to individual employees is typically determined by a performance appraisal process conducted by the employee's supervisor (confirmed below). Respondents were asked to indicate which criteria were used to rate performance for merit increases and if that criteria were used to rate its effectiveness. (See Table 2.) Note that the percentages reported indicate multiple performance criteria are used by most organizations. The top three performance criteria used by organizations to determine merit increases are:

1 | General competencies or behaviors associated with jobs, such as leadership, timely response to work demands, meets goals on time, works well with team (91%).

2 | Accomplishment of performance goals set for the job or person in the job (90%).

3 | Accomplishment of the job duties listed in the job description (80%).

It is probably no surprise that most organizations with merit pay programs use a combination of general competencies or behaviors and individual performance goals. However, given the time required by management to design behavioral measures for individual jobs, the authors were surprised to learn that behavioral-type measures (behaviorally anchored rating systems [BARS]) were used by over half the organizations. The authors also wondered about the wisdom of the 24% of organizations using 360-degree feedback, given the potential for bias among raters who receive little or no training (e.g., suppliers, subordinates and peers).

Almost two-thirds of the respondents reported that the specific performance criteria used to determine merit increases were effective or very effective. Less than half of the organizations that used the "team rating instruments" as criteria found them effective or very effective. Not surprisingly, most performance ratings were conducted by the employee's immediate supervisor (92%) with only a few relying on either managers at two or more levels above the employee (3%), multiple raters (2%) or some other rater (3%).

Table 2 | Effectiveness of Performance Increase Criteria Used to Award Merit Increases

	Frequency of Use	Not Effective	Marginally Effective	Effective	Very Effective
General competencies or behaviors associated with most jobs (e.g., leadership, timely response to work demands, meets goals on time, works well with team)	91%	2%	25%	58%	15%
Accomplishment of performance goals set for the job or person in the job	90%	3%	22%	56%	19%
Accomplishment of the job duties listed in the job description	80%	5%	30%	56%	9%
Exhibiting behavior associated with effectively performing the specific job (e.g., BARS)	59%	7%	26%	52%	15%
Open-ended: performance essays or discussions	48%	5%	34%	53%	7%
360-degree feedback	24%	15%	29%	44%	13%
Team rating instrument	12%	17%	35%	35%	13%

CHARACTERISTICS OF PERFORMANCE APPRAISAL PROCESS

Although most performance appraisal processes require supervisors to tell employees their rating, 13% of the respondents indicated it was not a requirement in their organizations. The findings show that a performance appraisal process that uses paper and may incorporate MS Word and MS Excel types of software is still widely used among organizations (43%). Fifty-six percent of respondents indicated they are using online software designed for rating employee performance. Surprisingly, few organizations use calibration or roll-ups of performance scores to monitor or control performance rating: 38% and 33%, respectively. Even fewer organizations use "forced ranking or distributions" to limit the number of top performance ratings given by supervisors (20%). Finally, most organizations use a four- or five-point rating scale to summarize employee performance for awarding merit increases (77%).

Respondents report that 50% of performance appraisal score distributions were a normal curve with 39% indicating that performance appraisal scores were skewed to higher ratings.

MERIT INCREASE BUDGETS, ADMINISTRATION AND AWARDS

Respondents report that merit budgets are primarily determined in advance as a percentage of payroll based on predicted revenues and what other businesses are budgeting for merit increases (79%). Only 17% of respondents budget merit pay increases through discretionary funding where management makes an ad-hoc decision before awarding the merit increases based on affordability, turnover, etc. One percent of respondents report a self-funded merit increase budget through reduced costs or increased revenue/sales (i.e., the increase is typically driven by a formula established in advance).

Table 3 indicates how the size of merit budgets is primarily determined (i.e., important and very important) by affordability, given labor costs, and expected revenues (93%), and success of the organization in meeting its profit margins, revenue and sales, or other financial goals (91%). To a somewhat lesser extent, merit budgets are determined by survey predictions of the amount other organizations are budgeting for merit pay increases (77%) and ability to attract and retain employees (73%). The authors were surprised that the "amount required to keep the organization's targeted position in the labor market" was considered either not important or marginally important by 44% of organizations. It would seem

Table 3 | Determinants of Merit Budget Size

	Not Important	Marginally Important	Important	Very Important
Affordability, given labor costs and expected revenues	3%	3%	33%	60%
Success of the organization in meeting its profit margins, revenue, sales, or other financial goals	3%	6%	33%	58%
Survey predictions (such as WorldatWork or Mercer) of the amount other organizations are budgeting for merit pay increases	12%	11%	35%	42%
Ability to attract and retain employees	8%	19%	45%	28%
Amount required to keep the organization's targeted position in the labor market (e.g., 50th percentile)	14%	30%	38%	18%
Conduct informal survey of competitors and/or own industry	33%	28%	27%	12%

that maintaining market position would be a more important determinant of pay increases than was reported.

Most merit increases are awarded annually, on the same date for all employees (82%) with a much smaller group awarding merit pay increases annually but not on the same date to all employees (11%). Few made merit increases dependent on individual performance ranging from a few months to more than a year (2%). Even fewer offered awards more than once a year (1%). Four percent of respondents had some other schedule for awarding merit increases.

Although one of the defining characteristics of merit pay increases is to roll the merit increase into base pay, 18% of organizations with merit programs do not do so. Fifty-nine percent adjust pay levels to keep up with the labor market and 35% adjust individual pay increases based on employee position in their pay range. Only 7% of organizations adjust base pay on inflation or according to organizational performance.

Annual bonuses are often used as supplements or in conjunction with merit increases. The study found that bonuses are paid when employee pay is at the top of the range (36%) and 27% of respondents indicated that bonuses are awarded with the merit increase for reasons other than being at the top of the pay range. Only 35% of organizations do not use bonuses in conjunction with merit increases.

The value of providing information about pay decisions to employees is often discussed in the journals. Although virtually all businesses tell employees the size of their pay increase or the amount of their new salary, it seems very little other information is shared in most organizations. Only 31% of organizations tell employees what their position is in the range and 10% share the average increase given to all employees.

Just over half of the respondents (58%) report using merit guide charts (i.e., merit matrices) to standardize the merit increase awards across their organizations. Of those that use merit guide charts, 91% standardize individual performance scores with merit increases and 72% standardize position in range. Only 10% standardize length of service since the last increase and 6% report using some other criteria to standardize merit increases.

Earlier, it was reported how software was used to administer the performance appraisal process. In terms of using software to administer merit increases, findings are similar. Microsoft Excel and other spreadsheets are used by 40% of respondents, 27% use HRIS software with merit pay add-ons, 16% use specialized compensation software and 11% use a performance appraisal software with merit pay add-on.

To drive performance or create a performance culture, it is suggested pay differentiation among high, average and low performers is important. Just 5% of respondents said their base salaries were not based upon performance, and 13% said that everyone receives about the same increase. Variations in merit pay increases were substantially different across organizations, with 27% of respondents indicating their organizations had small variation (increase for top performers is 1.25 times the average), 35% of respondents indicating that their organizations had medium variation (increase for top performers is 1.5 times the average), 20% of respondents indicating that their organizations had considerable variation (increase for top performers is 2 times the average), and 2% of respondents indicating that their organizations had extreme variation (increase for top performers is at least 3 times the average).

Of course, pay differentiation is determined in part by pay structure range spreads. Twenty-two percent of respondents reported their organizations had pay range spreads from 30% to 49%. Forty percent reported the range spreads as being from 50% to 69%. Few (15%) had no pay ranges and only 15% had range spreads over 70%.

CRITERIA USED TO EVALUATE MERIT PAY PROGRAMS

Table 4 lists the methods and criteria by which one could potentially evaluate a merit pay program and the frequency with which respondents used these methods. It was interesting that the most important criteria (very important and important) were the level to which employees understood the merit pay program and how their increase was awarded. This conflicts with the earlier finding that management shares very little information about an employee's pay. Furthermore, the authors have seen few surveys that attempt to measure employee understanding of the merit pay program and the increases they receive.

Table 4 | Criteria Used to Evaluate Merit Pay Program

	Not Important	Marginally Important	Important	Very Important
Employees understand the merit pay program and how their increase was awarded	6%	10%	41%	43%
Satisfaction of managers or supervisors with the merit pay program	6%	15%	53%	26%
Company/organization overall performance such as total shareholder return, revenues, etc.	16%	13%	38%	33%
Employee satisfaction with pay or merit pay or perceived justice	7%	22%	47%	23%
Employee turnover	8%	28%	44%	20%
Administrative efficiency of the appraisal process	13%	29%	45%	14%
Rating of your company (e.g., Fortune's Most Admired Companies)	57%	23%	15%	6%

It is not surprising that compensation and HR professionals report that manager and supervisor satisfaction with the merit pay program is an important criterion. However, the authors' experience has never indicated a direct link between company overall performance and the quality of the merit pay program. Seventy percent of respondents indicated that employee satisfaction with pay or merit pay was an important or very important criterion for evaluating the merit pay program.

As mentioned earlier, respondents represented organizations that varied considerably in size. However with just a few exceptions, size, both in terms of revenue and number of employees, does not seem to be related to program goals, assessment of effectiveness in meeting those goals and the way merit pay programs are designed. First, respondents from larger organizations report using more sophisticated technology for administering merit pay programs. Smaller businesses are more likely to use spreadsheets and larger organizations are more likely to use software that has been especially designed for merit pay programs. Second, variation in the size of merit pay increases is higher for larger businesses than for smaller ones.

CONCLUSIONS AND RECOMMENDATIONS

Findings from the survey of compensation and HR professionals indicate that basic characteristics of merit pay programs have changed little over the years from the designs proposed in the 1960s and 1970s. However, the size of merit increases has gotten substantially smaller and the available technology has made these programs easier to administer. This research indicates there are numerous goals to which merit pay programs are expected to contribute, but not all are of equal value. However, the assessed effectiveness indicates there are still substantial challenges with room for improvement.

Low merit pay increases in recent years have made it difficult to differentiate the rewards of high performers from those with only average performance. Furthermore, getting managers to differentiate performance across their employees is difficult. One strategy for improving merit pay that has been discussed in recent years is to separate pay adjustments based on labor cost increases from increases for good or exceptional performance. The former would be based on the cost increases in the labor market not on employee performance. Thus, merit increases that were previously rolled into base pay would be given as bonuses, which does not increase base pay and long-term fixed payroll costs.

It was interesting that, for the most part, merit pay programs for larger organizations were not fundamentally different from those of smaller organizations. This seems to indicate that design of merit pay programs is relatively known and does not require additional cost or larger employee numbers to implement different features of these programs. Thus, the findings seem to apply to all organizations, regardless of size.

Although this study provides an in-depth look at how compensation professionals evaluate their merit programs, it does not examine how employees or their managers view the merit pay program. The experience of the authors, which is collaborated by research, indicates that employees and their managers are much less positive about merit pay programs than the compensation department (Brown, 2001; Hills et. al. 1987; Salimaki and Jamsen 2010).

Based on the findings and the authors' experience, they recommend:

- Identify specific goals for merit pay programs and then monitor their effectiveness in achieving those goals. Without evaluating effectiveness administering merit pay becomes just an administrative process, which may not meet any particular strategic objectives.
- Compare the features of your merit pay program with the features of other organizations reported in this study. If you have different features, do those features support your program goals or detract from them?
- If you are not using guide charts (or merit matrices) to standardize ratings across the organization, consider doing so. Employees are very aware of how other supervisors rate employees and employees often compare their increases with other employees.
- Reconsider how much compensation information to share with employees and enhance transparency. If employees don't know the relative size of their pay increase, it is difficult for them to determine if, in fact, they are doing a good job or if they are being rewarded appropriately for the work that they do.

Link merit pay programs to organization performance by showing employees how the overall size of the merit budget is associated with the performance of the organization.

AUTHORS

Dow Scott, Ph.D. (dscott@luc.edu) is a professor of human resources at Loyola University Chicago and president of Performance Development International Inc. Scott is nationally recognized as a thought leader in compensation and HR program evaluation. He has more than 100 publications. His teaching, research and consulting have focused on the creation of effective teams, employee opinion surveys, performance improvement strategies, pay and incentive systems and the development of high-performance organizations. Before following an academic and consulting career, he held a variety of HR positions at B.F. Goodrich Co. Scott obtained a master's and Ph.D. from the School of Human Resources and Employment Relations at Michigan State University.

Rena Somersan (rena.somersan@verisightgroup.com) is a principal with the Compensation Consulting practice of Verisight. With over 20 years of diverse consulting experience assisting clients in executing their strategic HR and compensation initiatives, she has a degree in economics and Japanese from the University of Wisconsin and a master's degree in business administration. Somersan's expertise includes the design of workforce and executive compensation programs, performance management systems, variable pay plan designs and leadership development in a variety of industries. She is the 2014-2015 president of Metro Milwaukee SHRM

Brian Repsold, MBA, CCP (brian.repsold@verisightgroup.com) is a principal with Verisight's Compensation Consulting Practice. Repsold has more than 20 years of consulting experience partnering with clients and leading engagements linking organizational strategies with desired human capital performance and outcomes. His consulting experience includes developing compensation/performance management

systems, variable pay plan design, and evaluating sales roles and incentives to support strategic objectives. He has developed and lead numerous human capital benchmarking initiatives including compensation, benefits, employee engagement and best practices studies. Repsold has a bachelor's degree in economics from Northwestern University and a master's in business administration from Bellarmine University..

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