2. A Literature Review

Research Base and Background

- Expectancy Theory and Pay

The expectancy theory of motivation predicts that one’s level of motivation depends on the attractiveness of the rewards sought and the probability of obtaining those rewards. The theory has developed from the work of psychologists who consider humans as thinking, reasoning people who have beliefs and anticipation concerning future life events. Expectancy theory therefore holds that employees should exert greater work effort if they have reason to expect that it will result in a reward that is valued. To motivate this effort, the value of any monetary reward should be attractive. Employees also must believe that good performance is valued by their employer and will result in their receiving the expected reward.

Figure 1.1 shows the relationship between pay-for-performance and the expectancy theory of motivation. The model predicts, first, that high effort will lead to high performance (expectancy). For instance, if an employee believes she has the skills and abilities to perform her job, and she works hard (effort), then her performance will improve or be high. Second, high performance should result in rewards that are appreciated (valued). Elements of the compensation package are said to have instrumentality when an employee's high performance leads to monetary rewards that are valued.
While Productivity as measured by utilization of manpower or certain key equipment is important, rewarding workmen or other levels of employees only based on that can distort the priorities. For example, it is possible to raise productivity through wasteful energy or material consumption, but in that case the overall economics would be adverse. Likewise, single-minded pursuit of productivity is likely to gradually lead to degradation of quality. This is because the focus would be on somehow meeting the minimum attention to that aspect while concentrating on speed of output. A similar thing can happen concerning delivery schedules, with the tendency being to take up first those items and pieces, which move with least work and help, raise production but avoid the more difficult ones. These tendencies can be a creeping disease that builds into the system and can have disastrous consequences in the long run, in the increasingly competitive environment.
Money is important

Are rewards, particularly monetary rewards, really motivators? Put in another way, does money motivate employees?

Money is understood to be a powerful motivator for more than one reason. We are living in a money-motivated world and Money is Important! It is saying the obvious. But it still needs to be said, because economic incentives have not lost its power even after being used for centuries. Any amount of human relations cannot compensate for a lack of monetary reward. “Even dedicated cricketers do not wish to play for our country if the financial rewards are not attractive.” This situation is no different in the industrial world. Money is an effective element of compensation strategy used by an organization for attraction, retention, recognition and reward of key resources.

In the first place, money is fundamental for completion of a task. Work, unless it is voluntary or “play”, involves a contract between two parties “guaranteed” by the payment of money. Second, as a medium of exchange, money is the vehicle by which employees can buy numerous need-satisfying goods and services they desire. Third, money is one of the hygiene factors, and improving maintenance factors is the first step in efforts directed towards motivation. Fourth, money also performs the function of a “score card” by which employees assess the value that the organization places on their services and by which employees can compare their “values” to others. Fifth, reinforcement and expectancy theories attest to the value of money as a motivator. In the former, if pay is contingent upon performance, it will encourage workers to high levels of effort. (See figure 1.2) Consistent with the expectancy theory, money will motivate to the extent that it is seen as being ale to satisfy an individual’s personal goals and is perceived as being dependent upon performance criteria.
Sixth, money acts as punctuation in one’s life. It is an attention-getting and effect-producing mechanism. Money has, therefore, tremendous importance in influencing employee behaviour. Seventh, money is easily vulnerable for manipulation. Other factors like satisfaction, responsibility, a challenging job and the like are nebulous. Payments and the plans with which they are linked are manipulatable. Finally, money will be powerful motivator for a person who is tensed and anxious about lack of money. Many worries and concerns are financially based. It is relaxing to receive sufficient money to clear the outstanding bills and past debts which have been causing tensions.

Figure 1.2:

Pay and Performance - Relationship
However, little money has no effect. Lower levels of compensation leads to undesirable levels of performance. Any monetary reward given should be **significant** and in accordance with the **level of Performance**.

- **Performance Management**

What is Performance Management?
It is a style of management with its foundation in open communication between manager and employee that involves setting goals, providing ongoing feedback both from the manager to the employee and from the employee to the manager, as well as the performance appraisal. An effective performance management system helps both managers and employees to work smarter instead of harder to achieve productivity and profitability. An effective performance management system leads to increased profits, and outlines the manager's role in the process, including employee development, setting standards, ongoing monitoring and aligning with company goals.

Performance management reminds us that being busy is not the same as producing results. It reminds us that training, strong commitment and lots of hard work alone is not results. The major contribution of performance management is its focus on achieving results -- useful products and services for customers inside and outside the organization. Performance management redirects our efforts away from busyness toward effectiveness.

**The Performance Management context**
Both the transactional and transformational aspects of performance management take place within the context of the organization. This consists of its internal environment (its culture, structure, employee relations climate, technology, operational processes and management
practices) and its external environment (competition, economic trends, government interventions, etc).

Flannery et al. stresses that:
Two of the most important factors influencing performance and results are an organization’s climate – its values and culture – and its management practices, which include compensation.

The nature of Performance Management processes and initiatives are strongly affected by its environment, especially its work culture. A contingency approach is therefore necessary. Such an approach recognizes the desirability of ‘best practice’ but is also aware of the need to achieve ‘best fit’. When developing payment strategies, policies and processes it is essential to start with a systematic analysis of the organization’s business strategy and plans, culture, structure, management practices and operational processes. An understanding of current changes or plans for change is equally essential.

- Future Trends in Performance Management

The considerable developments in Performance Management that are taking place recently are associated with the changes in the economic and competitive environments in which the businesses operate and the ways in which they respond to external challenges. Performance Management is an extension of the organization’s business strategy. Trends in performance management can only be forecast in the light of predictions on how business strategies and programmes flowing from them are likely to develop. There is no doubt that changes in performance management over the last decade have been in response to changes in business strategies and practices which in turn have responded to changes in the competitive environment.
These changes have been summarized by Rosabeth Moss Kanter\(^1\) when she defines her model of the post-entrepreneurial corporation as a leaner organization with fewer ‘extraneous’ staff which ‘focuses on doing only those things in which it has competence’. She suggests that the post-entrepreneurial corporation ‘represents a triumph of process over structure… in contexts requiring speed and dexterity, what is important is not how responsibilities are divided but how people can pull together to pursue new opportunities’. Increasingly, people will have to learn how to function in constantly changing roles; indeed how to carry out simultaneously a number of different roles. They have to achieve a balance between concentrating on their own areas of skill and responsibility and working together with others. Businesses will have to look very hard at the ways in which they employ people, using value-added analysis techniques to ensure that each step is carried out in a work process and decision sequences augment the previous step.

It is these business trends which have governed the most important performance management developments in recent years, namely: a more strategic focus, a more flexible approach to job evaluation, greater focus on external relativities, a job family modeling, broadbanding, the assessment of inputs (competences) as well as outputs performance management processes, competence-related pay, team pay and flexible benefits.

The future does not necessarily include any quantum leaps in Performance Management practices. But environmental and organizational demands are encouraging developments such as those set out by Murlis\(^4\).
- well-developed career management programmes that enable employees to see how they can manage their own progression in an environment where promotion is rarer and more significant when it happens, and when building experience in different roles is the way to progress;

- well-designed and implemented performance management processes that often embrace the use of competences and so support development, as well as the achievement of objectives, and which link credibly to performance-related pay progression and other variable pay schemes;

- line management skilled in interpreting market data, making local pay decisions and operating and communicating the policies needed for this new environment;

- well-validated salary market ‘anchors’ for the new roles, which managers can review and use as background for pay budgeting and pay progression decisions;

- strong, locally based financial control and modeling systems to support decision making and help ensure the prevention of pay drift.

• **Performance-related Pay**

Performance-related Pay (PRP) links pay progression to a performance and/or competence rating. The rating could be carried out during a performance review, or it could be conducted at a different time exclusively for PRP purposes.
PRP normally provides for an increase in base pay which is governed by a rating against such criteria as performance and contribution outputs and skill and competence inputs. PRP has been a traditional component of the pay packet of many shop-floor workers, most sales staff are on some form of commission and executive bonus schemes in most companies.

The overall objective of PRP is to provide incentives and rewards which will improve the performance of the organization by improving individual performance.

To achieve this objective the aims of PRP are to:

- Motivate all employees to perform better – not only the high performers but also the core on whom the organization depends;
- Deliver a positive message about the performance expectations of the organization;
- Focus attention and endeavour on the key performance issues;
- Differentiate rewards to people consistently and equitably according to their contribution and competence;
- Help to change cultures where they need to become more performance and results oriented or where the development of other key values such as quality and customer service needs to be encouraged;
- Reinforce existing cultures and values which foster high levels of performance, innovation, quality and teamwork;
- Emphasize the importance of teamwork as well as individual contributions;
- Improve the recruitment and retention of high quality employees who will expect PRP as part of a well-managed working environment;
- Flex pay costs in line with organizational performance.
Definition: Performance Pay

The process of providing a financial or financially measurable reward to employees linked directly to individual, team or organizational performance, whether it be in the form of base pay or cash bonus payments.

Performance pay, in my view, forms a part of an integrated and strategic approach to reward. Although my thesis very much concentrates on pay, this does not mean that we underestimate the importance of non-financial rewards as a means of motivating and recognizing high contribution in any organization.

PRP put a greater emphasis on ‘paying for performance’ and attempt to ‘incentivise’ remuneration in order to improve individual and organizational performance and create a new performance-based culture. These schemes base pay on an assessment of the individual’s job performance. They provide ‘individuals with financial rewards in the form of increases to basic pay or cash bonuses which are linked to an assessment of performance, usually in relation to agreed objectives’ [Armstrong 1999:268]. Accordingly, pay is linked to performance measured by a number of specific objectives. This reflects a move towards rewarding output (rather than input), using qualitative (rather than quantitative) judgements in assessing performance, a focus on working objectives (rather than personal qualities), and an end to general annual across-the-board pay increases. (Fowler, 1988)
## Comparison of 1980s and today’s style pay for performance approaches:

<table>
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<tr>
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<tbody>
<tr>
<td>Organizing Philosophy</td>
<td>Formulas, systems</td>
<td>Processes</td>
</tr>
<tr>
<td>HR approach</td>
<td>Instrumentalist, people as costs</td>
<td>Commitment, people as assets</td>
</tr>
<tr>
<td>Measurement</td>
<td>Pay for results, the ‘whats’, achieving individual objectives</td>
<td>Multi-dimensional, pay for results and ‘how’ results are achieved</td>
</tr>
<tr>
<td>Measures</td>
<td>Financial goals</td>
<td>Broad variety of strategic goals: financial, service, operating etc</td>
</tr>
<tr>
<td>Focus of measurement</td>
<td>Individual</td>
<td>Multi-level: business, team, individual</td>
</tr>
<tr>
<td>Design</td>
<td>Uniform merit pay and/or individual bonus approach throughout the organization</td>
<td>Diverse approaches using wide variety of reward methods, to suit the needs of different areas/staff groups</td>
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</tbody>
</table>

Performance pay is not just a new set of pay schemed designs or delivery vehicles, but a much broader approach in which companies can address their strategic and process failings.

**Performance-related Pay: The questions**

The key questions our analysis has raised are as follows:
Q To what extent are performance-related pay schemes actually being withdrawn in practice?

Q Do performance-related pay schemes really motivate people and do they have any effect on individual and organizational performance?

Q If they are failing, why are they failing?

Q If individual performance-related pay is not appropriate, what should we be introducing instead?

Q What is the relationship between individual performance-related pay and competency, team and other pay methods? Is the latter coming in to replace performance-related pay?

Q Is there any one best system or approach to relating performance and pay, or is it totally dependent on the environment in which it operates?

Q Should we introduce and operate systems which link pay and performance in my own organization? If so, how do we make them work in practice?

**PRP decisions**

Decisions on whether or not to introduce or continue with PRP depend on an evaluation of its pros and cons in the light of the particular culture, environment and objectives of the organization. F. W. Taylor, the father of scientific management, viewed employees as rational and economic in their approach but basically lazy and having to be motivated by management through the pay system. Because employees are motivated primarily by money, it is important to ensure that the jobs that they are doing are capable of providing them the opportunity to maximize their earnings.
The Operation of PRP

PRP can operate in a pay structure by providing for different rates of progression within the pay range for a grade or a job according to performance.

A typical PRP system uses variable progression within a pay range. The main operational features of such a system are:

1. **Basic Characteristics**
   A PRP scheme provides for variable performance-related payments in a pay range. It provides for progression within the range to be determined by performance ratings. The basis for deciding on performance-related pay increases may be governed by guidelines on the allocation and distribution of ratings and how rewards should be related to ratings in accordance with the individual’s position in a pay range.

2. **Rating**
   The size of performance-related increases is typically governed by ratings. Ratings should be based on hard evidence, understood and trusted by those under review. The pay dimensions to be attached to these decisions are determined by policy guidelines and controlled within overall and departmental budgets.

3. **Size of performance-related increases**
   The size of performance-related increases is determined by the ratings within the framework of policies on pay progression and limits and the limits of pay review budgets. There are no firm guidelines on the desirable relationship between different levels of performance and the size of an increase.
As a rule of thumb, those whose performance is outstanding may deserve and expect rewards of 10 percent and more in their early period of a job. People whose level of performance and rate of development is well above the average may merit increases of between 7 and 9 percent, while those who are progressing well at the expected rate towards the fully competent level may warrant an increase of between 4 and 6 percent. Increases of between 0 and 3 percent may be justified for those who are not making such good progress but who are still developing steadily.

The amount largely depends on the type of organization, its culture and what it is prepared and able to give. The size of performance-related pay increases may be constrained by ability-to-pay considerations. If a lot has to be spent on increases to keep pace with market rates, less may be left in the pool for performance pay.

Performance-related pay increases may be affected not only by performance ratings but also by the individual's position in the pay range.

4. Progression rates and limits
A pay progression policy may provide for a movement-through-the-range element which enables individuals to reach the range of reference point if and when they achieve the required level of performance, skill and competence.

5. Performance Matrices
A performance matrix provides guidance on how increases should be related to different levels of performance according to the individual’s position in the pay range. The rates will be based on the organization’s progression policies and will need to be flexed at the time of the pay review. Matrices can be used flexibly and are helpful in large organizations.
The following factors need to be taken into account when devising or updating a performance matrix:

- The structure of the pay range, i.e. its dimensions and the position of the reference point. Different matrices will have to be drawn up in accordance with these dimensions.
- The basis of progression, e.g. decelerating – individuals are paid more for initial improvements in performance, but payments are proportionately less, higher up the pay range. This is the most typical pattern and reflects learning curve/market positioning.
- Market progression (low movement reduces scope for differentiation)
- The size of the increases.
- The likelihood that the majority of the employees will be covered by the central group of increases. Particular care would therefore have to be taken in deciding on the rates of increase in this area and they may have to be flexed more often.
- The limits to progression depending on performance.
• **Contingent Pay:**

The term Contingent Pay covers the various forms of additional financial rewards.

Contingent Pay consists of payments related to individual performance; contribution, competence or skill or to team or organizational performance. A distinction can be made between performance (what a person achieves) and contribution (the impact made by that person on the performance of the team and the organization). The level of contribution will depend on the competence, skill and motivation of individuals, the opportunities they have to demonstrate their competence and the use they make of the guidance and leadership they receive.

**Types of Contingent Pay:**

- Individual performance-related pay (PRP);
- Competence-related pay: The most familiar definition produced by Boyatzis\(^6\): An underlying characteristic of an individual which is causally related to effective or superior performance. Competence does not, therefore, just relate to present performance; it also predicts future performance because it is deemed to be a continuing characteristic which is normally irreversible.
- Skill-based pay
  - Shop-floor incentive and bonus schemes;
  - Salesforce incentive schemes;
  - Executive incentive and bonus schemes;
  - Employee and executive share schemes;
  - Team rewards;
  - Gainsharing;
- Profit sharing;
- Profit related pay;
- Other cash payments.

- The Rationale for Contingent Pay:

**Basic Reasons**

i) **Motivation**
Pay related to performance, competence or skill motivates people to achieve higher levels of performance and to increase the range and depth of their competencies or skills.

ii) **Message**
Contingent pay delivers a general message that the organization regards performance, competence or skill as important – ‘this is what we expect you to do and this is how we will reward you for doing it’. It can also deliver messages that certain values, behaviours or aspects of performance are important; for example quality, customer service, leadership and team-working.

iii) **Equity**
It is right and proper that pay should be related to people’s performance, contribution, competence or skill.

**Contingent Pay choice matrix**

<table>
<thead>
<tr>
<th>Time scale/Type of scheme</th>
<th>Instrumental schemes affecting</th>
<th>Schemes affecting commitment and retention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediate</td>
<td>Individual</td>
<td>Team</td>
</tr>
<tr>
<td>Medium Term</td>
<td>Performance and</td>
<td></td>
</tr>
<tr>
<td>Competence-related Pay</td>
<td>Profit Sharing</td>
<td>Skill-based Pay</td>
</tr>
<tr>
<td>------------------------</td>
<td>---------------</td>
<td>----------------</td>
</tr>
<tr>
<td>Long Term</td>
<td>Share option</td>
<td>Long-term incentive scheme</td>
</tr>
</tbody>
</table>

This matrix helps to make a choice of the scheme or mix of contingent pay schemes by summarizing the impact of different schemes in terms of motivation, commitment, retention and timescale.

- **Balanced Scorecard**

The measurement and management of performance at organization, team and individual level may use the ‘balanced scorecard’ approach. This concept was developed by Kaplan and Norton. It is based on the view that ‘what you measure is what you get’ and, overall, involves looking at the business from four related perspectives: customer, internal processes, innovation and learning, and finance. This process can be extended to teams and individuals and provides for a longer-term perspective on performance.

The **Balanced Scorecard** (BSC) provides us with the instrumentation we need to navigate to future competitive success. Today, organizations are competing in complex environments so that an accurate understanding of their goals and the methods for attaining those goals is vital. The Balanced Scorecard translates an organization’s mission and strategy into a comprehensive set of performance measures that provides the framework for a strategic measurement and management system. The Balanced Scorecard retains an emphasis on achieving financial objectives, but also includes the performance drivers of these financial objectives. The scorecard measures organizational performance across four balanced perspectives: financial, customers, internal business processes, and
learning and growth. The BSC enables companies to track financial results while simultaneously monitoring progress in building the capabilities and acquiring the intangible assets they need for future growth.

The Balanced Scorecard complements financial measures of past performance with measures of the drivers of future performance. The objectives and measures of the scorecard are derived from an organization's vision and strategy. The objectives and measures view organizational performance from four perspectives: financial, customer, internal business process, and learning and growth. These four perspectives provide the framework for the Balanced Scorecard. (See figure 1-1)

Linking the Balanced Scorecard to Compensation

Today's managers recognize the impact that measures have on performance. But they rarely think of measurement as an essential part of their strategy.
Effective measurement of performance is an integral part of the management process. A Balanced Scorecard provides executives with a comprehensive framework that translates a company’s strategic objectives into a coherent set of performance measures. Conventional performance measurement systems focused on control, but a **Balanced Scorecard** approach to performance focuses on vision and strategy.

In addition, while traditional financial measures report on what happened last period without indicating how managers can improve performance in the next, the scorecard functions as the corner stone of a company’s current and future success.

It is the core of the management system. Much more than a measurement exercise, the balanced scorecard is a management system that can motivate breakthrough (competitive performance) improvements in such critical areas as product, process, customer and market development. It enables the company to translate business unit strategies into a measurement system that meshes with the entire system of management.

A key challenge in executing any strategy is communicating the plan throughout the organization. It is this very communication that shows the employees how their everyday actions support the firm’s mission. The Balance Scorecard makes the strategy a continuous process owned by everyone, not just top management. It strengthens alignment throughout the company by communicating high-level goals down to all levels of the organization. Employees know not only what to do, but WHY. It is forward-looking as it shows how to translate current resources—particularly intangible assets like employee knowledge—into future, tangible results.

The balanced scorecard is not a template that can be applied to business in general or even industry wide. Different market situations and competitive
environments require different scorecards. Each situation has to be studied in depth and a suitable scorecard be “tailored” for that specific situation. Business units devise customized scorecards to fit their mission, strategy, technology, and culture. Anything radically different and without active participation of all concerned is bound to fail.

- **Balance in the Balanced Scorecard**

The concept of balance is central to this system, specifically related to three areas:

1. Balance between financial and non-financial indicators of success: The Balanced Scorecard was originally conceived to overcome the deficiencies of a reliance on financial measures of performance by balancing them with the drivers of future performance. This remains a principal tenet of the system.

2. Balance between internal and external constituents of the organization: Shareholders and customers represent the external constituents expressed in the Balanced Scorecard while employees and internal processes represent internal constituents. The Balanced Scorecard recognizes the importance of balancing the occasionally contradictory needs of all these groups in effectively implementing strategy.

3. Balance between lag and lead indicators of performance: Lag indicators generally represent past performance. Typical examples might include customer satisfaction or revenue. Although these measures are usually quite objective and accessible, they normally lack any predictive power. Lead indicators are the performance drivers that lead to the achievement of the lag indicators. They often include the measurement of processes and activities. On-time delivery might represent a leading indicator for the
lagging measure of customer satisfaction. While these measures are normally thought to be predictive in nature, the correlations may prove subjective and the data difficult to gather. A Scorecard should include a mix of lead and lag indicators. Lag indicators without leading measures do not communicate how targets will be achieved. Conversely, leading indicators without lag measures may demonstrate short-term improvements but don’t show whether these improvements have led to improved results for customers and ultimately shareholders.

- **The Balanced Scorecard as a Management System**

What you measure is what you get. A balanced scorecard is a set of measures that gives top managers a fast but comprehensive view of the business. The balanced scorecard includes financial measures that tell the results of the actions already taken. And it complements the financial measures with operational measures on customer satisfaction, internal processes, and the organization’s innovation and improvement activities—operational measures that are the drivers of future financial performance.

The Balanced Scorecard emphasizes that financial and non-financial measures must be a part of the information system for employees at all levels of the organization. Front-line employees must understand the financial consequences of their decisions and actions; senior executives must understand the drivers of long-term financial success. The objectives and the measures for the Balanced Scorecard are more than just a somewhat ad hoc collection of financial and nonfinancial performance measures; they are derived from top-down process driven by the mission and strategy of the business unit. The BSC translates a business unit’s mission and strategy into tangible objectives and measures.
The scorecard encourages a dialogue between business units and corporate executives’ and board members, not just about short-term financial objectives, but about the formulation and implementation of a strategy for breakthrough performance for the future.

- **Measures that move companies forward**

As companies have applied the balanced scorecard, we have begun to recognize that the scorecard represents a fundamental change in the underlying assumptions about performance measurement. We cannot implement the balanced scorecard without the involvement of the senior managers who have the most complete picture of the company’s vision and priorities. This was revealing because most existing performance measurement systems have been designed and overseen by financial experts. Rarely do controllers need to have senior managers so heavily involved.

Traditional performance measurement systems specify the particular actions they want employees to take and then measure to see whether the employees have in fact taken those actions. In that way, the systems try to control behaviour. Such measurement systems fit with the engineering mentality of the Industrial Age.

The Balanced Scorecard, on the other hand, is well suited to the kind of organizations many companies are trying to become. The scorecard puts strategy and vision, not control, at the center. It establishes goals but assumes that people will adopt whatever behaviours and take whatever actions are necessary to arrive at those goals. The measures are designed to pull people towards the overall vision. Senior managers may know what the end result should be, but they cannot tell employees exactly how to achieve that result, if only because the conditions in which employees operate are constantly changing.
This new approach to performance measurement is consistent with the initiatives under way in many companies: cross-functional integration, customer-supplier partnerships, global scale, continuous improvement, and team rather than individual accountability. By combining the financial, customer, internal process and innovation, and organizational learning perspectives, the balanced scorecard helps managers understand, at least implicitly, many inter-relationships. This understanding can help managers transcend traditional notions about functional barriers and ultimately lead to improved decision making and problem solving.

The balanced scorecard keeps companies looking - and moving - forward instead of backward.